Understanding your college savings options

Parents today have more choices than they've ever had for college savings. While that variety gives parents more flexibility, it also requires parents to do more research to make sure they pick a strategy that's right for them.

By the numbers

- 49 states and the District of Columbia offer 529 college savings plans
- Education Savings Accounts allow you to invest up to $2,000 per year.
- 529 college savings plans typically allow you to invest $200,000 or more over the life of the account.

Following is a general overview of the college savings options available today, along with a chart that will help you compare their key features and benefits. As always, you'll want to discuss your needs with an investment professional before making a decision. Also, be mindful of the fact that the specific features available in 529 plans vary from state to state.

Coverdell Education Savings Account (ESAs)

These plans, originally known as Education IRAs, were introduced in 1997 but only let parents set aside $500 per year. The plans now have a new name and higher contribution limits. Now parents can invest up to $2,000 per year in these accounts. The earnings on your investments in these accounts are free of taxes as long as your withdrawals are made to pay for qualified college expenses. Under new rules, money in the accounts can be used to pay not only for college but also for education expenses parents incur for children in grades K-12.

ESAs can also be converted to 529 plans without the account owner incurring any type of tax penalty.

Generally, when applying for financial aid, students are expected to use 35% of their assets to pay for each year of college, while parents' assets are assessed at a maximum rate of 5.6%. ESAs are considered to be an asset of the

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Key points

Coverdell ESAs

- Allow investments of up to $2,000 per child, per year
- Earnings are free of taxes when withdrawn for qualified elementary, secondary, and post-graduate educational expenses. Nonqualified withdrawals are subject to both income taxes and a 10% federal tax penalty on earnings.

529 plans

- Allow investments in excess of $200,000 over life of account
- Earnings are tax deferred and withdrawals are free from federal tax through 2010 if used for qualified higher education expenses. Nonqualified withdrawals are subject to both income taxes and a 10% federal tax penalty on earnings. Unless Congress extends the law, the federal tax treatment of 529 plans will revert to its status prior to January 1, 2002.

Custodial accounts

- allow unlimited investment amounts
- all or part of earnings are taxed at child's income tax rate

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE
NOT A DEPOSIT | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

custodian, typically the parents, when applying for financial aid, and can therefore have less of an impact on the amount of financial aid received than money in a custodial account would.

529 prepaid tuition plan and college savings plans

These plans are generally offered by the states (although a consortium of colleges now also offers a prepaid plan). 529 plans, named for the section of the Internal Revenue Code that governs them, come in two varieties — prepaid qualified tuition plans and college savings plans.

Both types of plans allow annual taxes on account earnings to be deferred. At least until 2010, earnings withdrawn from the account are also free of taxes if they're used to pay for qualified education expenses. (Congress will have to pass additional legislation for the tax-free benefits of 529 plans to extend beyond 2010.)

The prepaid tuition plans offer protection against future tuition increases. They let parents buy tuition credit at today's prices, and the credits can be used years down the road when your children are ready for college. (Not all states, however, guarantee their prepaid plans.)

College savings plans don't offer any guarantees on investment returns but, like an IRA or 401(k), they allow the account owners to choose their investment strategy from among the options offered under the particular plan. These plans offer parents the potential to earn returns above the yearly tuition inflation rate, which is the effective return a prepaid plan offers. (The savings plan accounts will not grow at all, however, if there are not earnings on the investments parents choose.)

Forty-nine states and the District of Columbia offer 529 college savings plans. Many plans are national and thereby available to residents of any state. About half of the states' plans offer in-state residents additional state income tax benefits. Still, even parents who live in states with tax benefits for residents may want to compare all of their options. A college saving plan from another state may offer advantages — such as better investment performance, plan features, or flexibility — that could outweigh the tax benefits of participating in the in-state plan.

Like an ESA, money in 529 plans is considered the account owner's asset. If a student is not the account owner, it could be expected that a 529 plan won't reduce financial aid as much as money in a custodial account can.

When putting money into 529 plans, however, parents need to be mindful of the fact that they may have an additional plan fee that other investments, such as custodial accounts, do not have. Also, investments in 529s involve investment risks. You should consider your financial needs, goals, and risk tolerance prior to investing.

529 plans also offer unique gifting and estate tax benefits. Under current rules, you can gift up to $11,000 a year ($22,000 per married couple) per beneficiary without federal gift-tax consequences. The unique feature of 529 plans allows you to gift up to $55,000 ($110,000 per married couple) to each beneficiary. You will not incur federal gift taxes as long as no additional gifts are made to the beneficiary for four years after the year during which you make the one-time gift.

Custodial accounts

These are the old standbys for college savings. They are also known as UGMAs and UTMAs, which are the initials for the state laws that govern them – either a Uniform Gifts to Minors Act or Uniform Transfers to Minors Act.

Custodial accounts don't offer the potential to defer and potentially escape taxes on investment earnings. But they do have significant tax benefits. Any or all of the earnings in a custodial account is taxed at the child's generally lower income tax rate. The tax treatment of the earnings depends on the child's age and the amount of earnings realized each year. (If the child is age 14 or over, all of the earnings are taxed at his or her rate. If the child is under age 14, the earnings are taxed at the child's rate up to a certain limit, then the parent's income tax rate applies.)

With custodial accounts the parent, as custodian, can select the account investments and exchange between various types of investments as they wish.

One potential disadvantage of custodial accounts is that they become the child's asset once he or she reaches

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the legal age of adulthood, which is either 18 or 21 depending on your state. If a child wishes to use the money for a purpose other than college, the parent has no legal right to stop him or her.

Because the money in the accounts is considered the child's, the accounts also can reduce financial aid more than money in a 529 or ESA would.

One advantage of custodial accounts, however, is that they don't have the additional plan fee that many 529 plans do.

Resources

Chany, Kalman A., *Paying for College Without Going Broke,* (Princeton Review Series, 2003 edition, $20.00)

Hurley, Joseph F., *The Best Way to Save for College — A Complete Guide to Section 529 Plans.* (BonaCom Publications. 2003, $22.95.)

College Board
www.collegeboard.com

Saving for College
www.savingforcollege.com
An Internet guide to 529 plans, this site offers investment results, new developments, and a frequently asked questions section.

Contact your investment professional for more information.

This material is not intended to replace the advice of a qualified attorney, tax adviser, investment professional, or insurance agent. Before making any financial commitment regarding the issues discussed here, consult with the appropriate professional.

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Make educated decisions

College investing programs come in many shapes and sizes today. That's why the insight and guidance of an investment professional is so valuable. He or she will not only help you choose the right college plan but also can help you select the investment options that best fit your needs and tolerance for risk.

Features	529 college savings plans	Custodial accounts (UGMA/UTMA)	Coverdell Education Savings Accounts	529 prepaid tuition plans
Income tax treatment	Tax deferred. Nonqualified withdrawals subject to income taxes and 10% federal tax penalty. Withdrawals are tax free if used for qualified higher education expenses.	Earnings taxed at beneficiary's rate	Tax free. Nonqualified withdrawals subject to income taxes and 10% federal tax penalty. Withdrawals are tax free if used for qualified education expenses.	Tax deferred
Contribution limits	In excess of $200,000 per beneficiary varies by plan	None	$2,000 per child per year	Varies by state
Income limits	No limits	No limits	Eligibility phases out for single filers at $95,000 to $110,000; for joint filers at $190,000 to $220,000	No limits
Control of assets	Account owner	Custodian until child reaches majority, then the child	Account owner	Account owner
Investment flexibility	Assets may be moved among funds offered once each calendar year or when you change beneficiaries.	You can move your assets as often as you want, but each transfer usually is a taxable event.	You can move your assets as often as you want.	State manages investments; offers return tied to tuition inflation rate
Estate planning features	Assets are transferred out of the owner's estate. Owner retains control.	Assets are transferred out of the estate.	Assets are transferred out of the owner's estate. Owner retains control.	Assets are transferred out of the owner's estate. Owner retains control.
Uses	Can be used for almost any accredited post-secondary school	No restrictions	Can be used for any qualified educational expense, including elementary, secondary, and post-graduate	Usually restricted to participating schools; can cover only tuition and fees
Ability to change beneficiaries	Can be transferred to another member of the same family without penalty	Not permitted	Can be transferred to another member of the same family without penalty	Many plans require that the beneficiary be a resident of the offering state.
Penalties on nonqualified withdrawals	Ordinary income taxes and a 10% IRS penalty on earnings	None	Ordinary income taxes and a 10% IRS penalty on earnings	Fees or penalties vary by state. Typically, the donor gets principal back, plus a modest return.