Saving for College: A Guide to Get Started

Saving for college is one of the biggest financial goals you'll have. Here's a guide on how to do it strategically.

You and your spouse may argue whether junior will attend mom's alma mater or dad's, but there's one thing parents can't debate: College is going to come with a hefty price tag.

According to The College Board's College Cost Calculator, in 15 years the cost of attending a public, in-state, four-year college will reach almost $45,000 a year, assuming college costs see a 5 percent annual inflation rate. Out-of-state public colleges, meanwhile, could surpass $70,000 a year, and private schools could exceed $87,000.

With figures like that, it's easy to fall into the trap of preparing from a place of panic — or even wondering whether, dollar-for-dollar, the diploma will be worth the money. But analysis by the Federal Reserve shows that the annual economic return of a college degree has held steady at 15 percent for more than 10 years, based on data that shows the earnings gap between college and high school graduates continues to grow faster than tuition costs do. That's a return that most investors would consider solid.

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SAVE NOW. OR PAY LATER.

To understand why it's so beneficial to save early, you have to understand the concept of compound growth. Compound growth is basically when you earn (or are charged) interest not only on your principal, but also on prior interest. So compound growth can benefit you or work to your detriment, depending on whether you're saving or borrowing money.

For example, let's say you want to cover college for your newborn that, today, costs $20,000 a year. If we assume college costs experience a 5 percent annual inflation rate, by the time your child graduates, four years of college would total $207,456. In order to be able to cover that amount, you'd have to save $448 per month, from birth, in a 529 plan that sees a hypothetical 6 percent annual investment return, according to SavingforCollege.com. By graduation, your contributions would total about $113,000 and you'd have earned more than $94,000 in interest.

THE SIGNIFICANT COST OF BORROWING

COST BY SAVING		COST BY BORROWING
$113,000	VS	$276,383

Cost of college for a newborn today. Assumes $20,000/year tuition and 5% annual inflation.

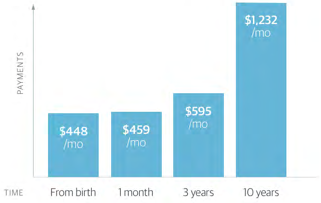
Now rather than save, let's say your family decides to borrow in the future to help cover those same four years of college. Your child would graduate owing about $276,383 in loans, assuming the loans charge a 6 percent interest rate. That translates into a payment of roughly $2,300 a month if the loan was paid back over 10 years (usually the standard repayment period). In other words, college would end up costing your family an additional $163,383 — or more than double your out-of-pocket costs — if you decided to borrow later instead of saving and investing in advance.

TIPS FOR SAVING

If you're planning to foot your child's tuition bill, it's important to start early, contribute often and invest in strategically.

Putting off saving can also cost you money: The longer you wait, the bigger your monthly contribution will need to be in order to hit the same savings goals. For example, waiting even a month after birth to start saving pushes your payment up to approximately $459 per month (in a tax-free account like a 529 plan). Waiting three years pushes it up to $595 per month, and waiting 10 years increases it to $1,232. Saving into a taxable account makes those payments even higher.

THE SOONER YOU START SAVING, THE BETTER



OPTIONS TO SAVE

The government has created two plans to help save for a child's education. There's the 529, a state-level plan, and the Coverdell Education Savings Account, which is created at the federal level. Both offer tax advantages that you can't get via other ways to save, like investments and custodial accounts, and they also have different rules for contributions and disbursements that you should be aware of.

529 COLLEGE SAVINGS PLAN

Saving for college is a key goal. A 529 plan is a flexible, state-sponsored plan that allows parents, grandparents, relatives and friends to invest for a child's higher education on a tax-advantaged basis (the catchy name comes from the IRS code section that authorizes it, in case you were wondering). Important things to know:

Your college savings grow tax-free

The money set aside in a 529 plan grows free of federal income taxes (and in some cases, state taxes). When the money is used for qualified college costs (like tuition, room and board, fees, books, supplies and equipment), those distributions are also tax-free.[1]

In addition, up to $10,000 per year can be taken out tax-free to help pay for tuition at a private or religious elementary or secondary school.

You decide how to invest your money

The 529 plan is similar to a 401(k) plan in that your savings are invested in a choice of professionally managed investment options. Your account value will go up and down based on the investments' performance.

You can change the choice of investments up to two times in a given calendar year.

You can set aside significant sums

You can contribute to a 529 plan regardless of how much you earn, and you can contribute how and when you want up to the lifetime limit (it varies by state, but often exceeds $250,000 per beneficiary). Federal tax rules allow you to contribute up to $15,000 per year per beneficiary ($30,000 for married couples filing jointly) without incurring federal gift taxes. Contributions must be made in cash.

You can gift a lump sum

A unique feature of the 529 plan is you can also gift a lump sum of up to five years' worth of contributions in one year, for a maximum of $75,000 from an individual (or twice that for joint gifts) without gift-tax implications. The hitch: You can't give additional funds to the same child or grandchild within the five-year time period.

You can get income-tax deductions

In more than 30 states, you can receive either a state income tax deduction or a tax credit for your contributions to the state's 529 plan. The rules vary from state to state, so check with your financial professional about the plan that best meets your needs.

You retain control of your money

The 529 plan offers flexibility in how you invest and how the funds are used. For example, it's possible to invest in a state plan outside of the state where you live (though you might not receive the tax credit) and the money can be used at any accredited institution, not just schools in the state sponsoring the plan. Even after your child turns 18, you retain control of the account, and if your child doesn't need the money, it can be transferred to another beneficiary in the same family (assuming he or she hasn't exceeded the lifetime benefit). You can also leave the money in the account for future use, but if you do withdraw funds for non-qualified expenses, you may be required to pay income tax and a 10 percent penalty on the earnings.

DID YOU KNOW?

Anyone can contribute to a 529 Plan. Grandparents, aunts, uncles, even friends can help you pay to send your kids to college.

COVERDELL EDUCATION SAVINGS ACCOUNT

A Coverdell Education Savings Account offers another tax-advantaged way to save. As with a 529 plan, your money grows tax-free, and you pay no taxes on withdrawals if they're used to pay for qualified education expenses. However, Coverdells are different thana 529 in a few important ways:

Income is limited for contributors

The money set aside in a 529 plan grows free of federal income taxes (and in some cases, state taxes). When the money is used for qualified college costs (like tuition, room and board, fees, books, supplies and equipment), those distributions are also tax-free.[1]

Total yearly contributions cannot exceed $2,000 per child

Be especially careful if multiple family members have accounts for the same child; there's a penalty for exceeding the limit.

The child must be younger than 18 when the account is opened

Withdrawals must be completed by the time he or she reaches 30 (except in the case of a beneficiary with special needs).

The money can go to a variety of qualified expenses

Elementary, secondary and postsecondary education count as qualified expenses, in contrast to a 529 plan, which is specifically for higher education.

You can direct your Coverdell contributions to whatever investment vehicles you want

A 529 plan limits investment options — typically to mutual funds

OPTIONS BEYOND THE 529 PLAN AND COVERDELL

1

TRADITIONAL INVESTMENT ACCOUNTS

These have the advantage of having no income or contribution limits, and the assets can be used for any purpose, including for college savings. But you will pay taxes on your earnings, even if the money is used to pay for education.

2

DEBT-TO-INCOME RATIO

Your permanent life insurance policy can help provide money for college by ensuring that if anything happens to you, your goals for your child's education can be met. Plus, you build cash value in your policy that can be accessed via withdrawals, loans or reducing the amount of your death benefit for any reason, including funding college expenses. The cash value of the policy grows tax-free and may be utilized tax- and penalty-free up to the amount of premiums paid (in other words, not including interest or gains).

3

CUSTODIAL ACCOUNTS

The Uniform Gift to Minors Act (UGMA) and Uniform Transfer to Minors Act (UTMA) are accounts that let you set aside money for the benefit of a child — with no restrictions that the money be used for education. There are also no contribution and income limits, but the contributions you make are irrevocable, meaning you can't take them back. And once the child reaches the age of majority in their state (typically 18 to 21), they have control over how the money is used. The IRS also offers some tax breaks, up to a certain amount, on the investment income earned in custodial accounts.

4

ROTH IRA AND TAX-ADVANTAGED ACCOUNTS

If you have a Roth IRA, your after-tax contributions (but not the earnings) can be withdrawn tax- and penalty-free to pay for college expenses. However, if you withdraw any investment earnings, that money may be subject to federal income tax and a 10 percent penalty, even if that withdrawal is used for qualified educational expenses.

Withdrawing from other qualified retirement accounts follow similar rules, so you should consult your financial planner or professional if you're thinking of going this route — not only to understand related taxes and penalties, but also because you don't want to fund your child's education at the risk of compromising your own retirement security. Children have options for funding their higher education with loans and scholarships — retirees don't.

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[1] If the money is used for a purpose other than qualified education expenses, the earnings portion of the withdrawal would be subject to then-current federal income tax, plus an additional 10 percent tax penalty and any applicable state taxes.

Past performance is no guarantee of future results. Examples are for illustrative purposes only and not indicative of any investment.

No investment strategy can guarantee a profit or protect against loss. All investing carries some risk, including loss of principal invested.

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Each method of utilizing your permanent life insurance policy's cash value has advantages and disadvantages and is subject to different tax consequences. Surrenders of, withdrawals from and loans against a policy will reduce the policy's cash surrender value and death benefit, and may also affect any dividends paid on the policy. As a general rule, surrenders and withdrawals are taxable to the extent they exceed the cost basis of the policy, while loans are not taxable when taken.

Loans taken against a life insurance policy can have adverse effects if not managed properly. Policy loans and automatic premium loans, including any accrued interest, must be repaid in cash or from policy values upon policy termination or the death of the insured. Repayment of loans from policy values (other than death proceeds) can potentially trigger a significant tax liability, and there may be little or no cash value remaining in the policy to pay the tax. If loans equal or exceed the cash value, the policy will terminate if additional cash payments are not made.

Policyowners should consult their tax advisors about the potential impact of any surrenders, withdrawals or loans.