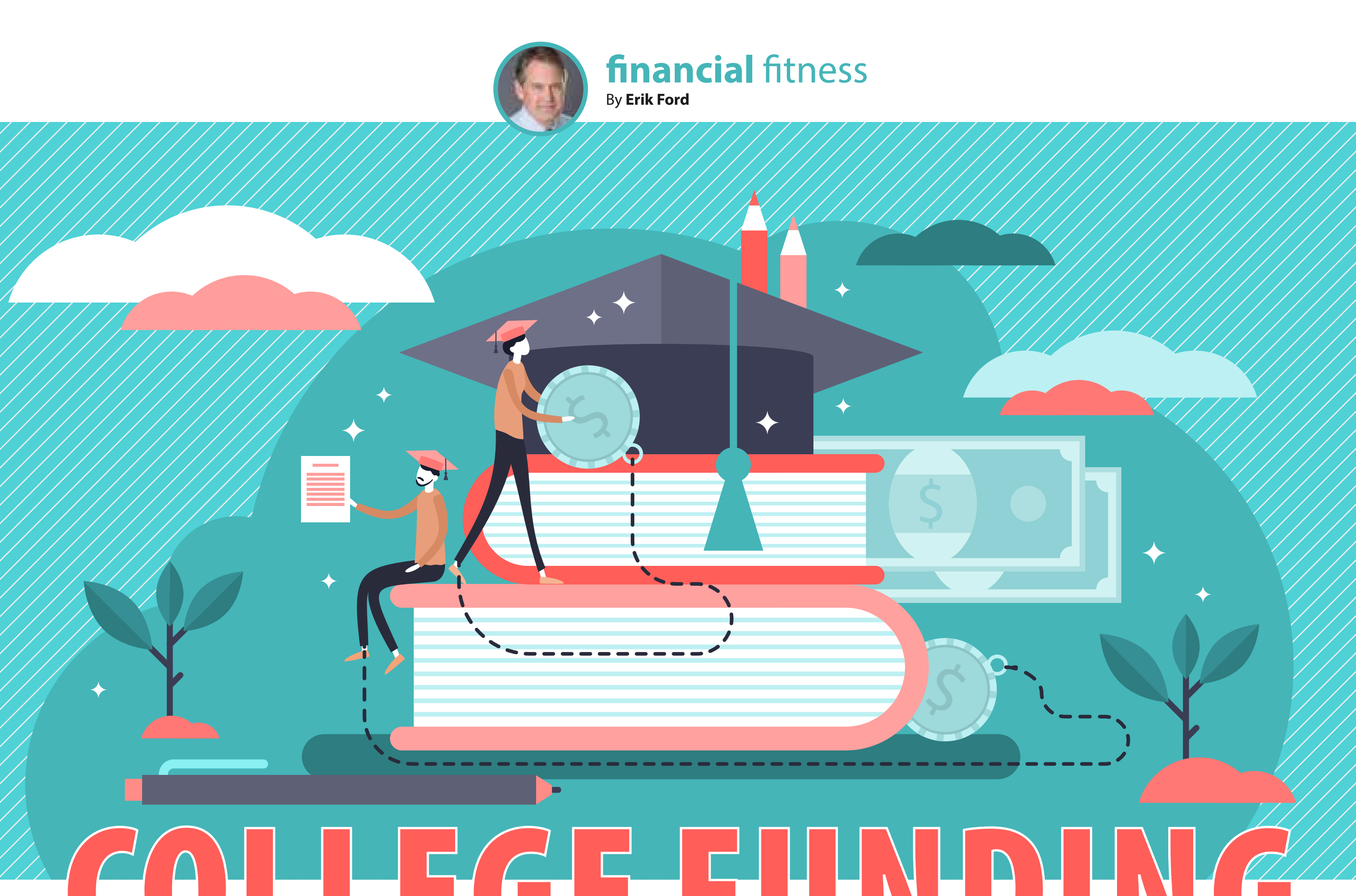
financial fitness
By **Erik Ford**



COLLEGE FUNDING

As we enter the Fall and the start of another school year, college is one year closer for our children, as is the need to pay the ever-increasing cost of attending college. Higher education has been one of those costs that have increased well in excess of the rate of inflation for years, making costs jaw-dropping when the time comes to send our young adults off for the next steps in their lives.

So how do we prepare for it? What are the choices and pros and cons? In this article we will touch on several alternatives but focus on the benefits of the state 529 college savings programs, without going into the details of any specific program.

Of course, one way to pay for college is to do so with current income or loans. With costs ranging from $40,000 to $70,000 a year (before any financial aid), few families can comfortably pay for college from current income and loans may saddle parents, students, or both for years with repayment. The largest segment of consumer debt is already student loans and is getting plenty of press because of its impact on the economy.

Saving is obviously a prudent way to prepare for this expense. There are choices on how to save and each has its relative benefits and costs. An account may be set up in the name of the parents for saving and investing funds for the future expense. This would be a taxable account so the ongoing earnings of the account would be subject to tax for the parents as well as any eventual realized capital gains. The benefit of such an account is that it is flexible. It can be used for other purposes if needed of if your child does not attend college.

You could also establish a custodial account in the name of a prospective student. This account is similar to the investment account above but is in the name of the child with the parent as custodian until the child reaches the age of majority. This age ranges from 18 to 21 depending on the state, but once that age is reached the funds are fully controlled by the child. Both of these investment account alternatives are fully included in the analysis for financial aid under the Free Application for Federal Student Aid (FAFSA).

A third investment/savings avenue are the state-sponsored college savings programs, commonly referred to us as 529 accounts. These accounts, established by state-sponsored programs allowed under federal tax law, provide a much more tax-efficient savings vehicle for saving for college expenses. Additionally, 529 balances are treated more favorable in financial aid analysis. These programs vary state to state. We will focus on the rules applying to the Illinois programs but will not specifically cover the details of the Illinois plans themselves. Each state treats their program differently for taxes and other factors. If you happen to live in a state other than Illinois, you should research the state specific details.

A 529 account is set up in the name of an adult (the participant) for the benefit of a prospective student (the beneficiary). In Illinois, contributions of up to $10,000 per taxpayer can be deducted from your income for state income taxes, meaning a couple may deduct up to $20,000 in contributions from their income for Illinois state income taxes. This is the total amount allowed for state tax deductibility, not a per student limit or a total contribution limit, which is important to note. Others may also contribute and take the state tax deduction (as long as they are state taxpayers), such as grandparents, aunts, uncles, etc. These rules for state tax treatment are for Illinois and differ from state to state.

After the tax benefit of the contributions, as long as the accounts are used for higher education, none of the income and gains from the account are taxable at either the state or federal level.

This is a powerful tool to allow the growth of account to be fully available for college rather than a portion being siphoned off for taxes.

One of the things about college savings that escape many is that the time horizon is much shorter than retirement savings. This means that it may be prudent for the investments targeted for college savings to be moved toward more conservative investments as the start of college approaches, so you do not experience a sharp decline in account value just as the funds are required. These programs offer an option that addresses this by offering age-based portfolios that adjust as college approaches, reducing portfolio risk when it can least afford to be taken.

As each state has its own program and people may move from one state to another, the question arises as to transfers. Generally, you can transfer balances from one program to another. However, the tax benefits of doing so are also state dependent. In the case of Illinois, transfers of original contributions from other programs are treated as tax-deductible contributions in Illinois. Gains transferred are not deductible.

A recent federal tax law change allows for 529 funds to be used for secondary school expenses, subject to state program rules. As of now the Illinois plan does not permit withdrawals for secondary education expenses.

A final note on the use of 529 funds for education is how you make withdrawals. From a documentary standpoint, having the funds transferred directly to the college or university is the best route. You can withdraw funds to reimburse yourself for qualified expenses you have paid, but that will entail documenting the details on your tax forms, whereas payment sent directly to a qualified institution is a non-event for tax documentation. Also, if you reimburse yourself or the student, it needs to be done in the same tax year as the expenses were paid. This can create a problem if you pay Spring expenses in December but want to reimburse yourself in January.

This has been a quick overview of alternatives and a focus on the relative benefits of state-sponsored 529 programs. Obviously, there is much more to this topic than we can cover in a brief article. Starting as early as possible and finding the right savings vehicle is important to being financially prepared for college. The rest is up to the student. Before engaging any strategy, you should consult you tax and financial advisors.

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Investors should carefully consider investment objectives, risks, charges, and expenses. This and other important information are contained in the fund prospectus, summary prospectuses and 529 Product Program Description, which can be obtained from a financial professional and should be read carefully before investing. Depending on your state of residence, there may be an in-state plan that offers tax and other benefits which may include financial aid, scholarship funds, and protection from creditors. Before investing in any state's 529 plan, investors should consult a tax advisor. If withdrawals from 529 plans are used for purposes other than qualified education, the earnings will be subject to a 10% federal tax penalty in addition to federal and, if applicable, state income tax.