


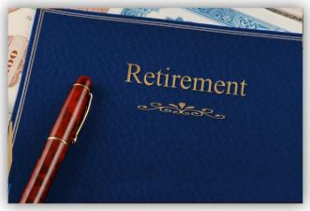

Ways to Pay For College

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Disclaimer

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Ways to Pay for College

At Younger Ages

If possible, a college savings program should be started when a child is young.

- **Personal Savings:** Funds put aside by parents or grandparents in taxable investment and savings accounts.
- **Tax advantaged approaches:** IRC Sec. 529 plans,[1] Coverdell Savings Accounts, or U.S. Savings Bonds.

The High School Years

As college draws closer, continue any savings programs begun in the past.

- **Scholarships and grants:** Many college scholarships or grants are awarded to students while they are still in high school.

During College

If savings are inadequate, other resources will be needed. Consider the following:

- **Student aid:** Frequently a "package" which may include grants, loans, scholarships, or work-study programs, with much of the funding coming from the federal government. Individual states, private individuals, and many colleges and universities are also a source of scholarships and grants.
- **Military programs:** The U.S. military has a number of programs to enable prospective, active duty, and former service personnel to attend college.
- **Tax benefits:** Federal income tax law encourages higher education in a variety of ways, including education tax credits and a deduction for student loan interest.[2]
- **Other approaches:** The cost of education can be reduced by living at home or choosing a lower-cost state or community college. A home-equity loan or a loan from an employer-sponsored qualified retirement plan may provide additional funds.

After Graduation

For some students, paying for college extends beyond the college years.

- **Perform any required service:** Some programs require the student to perform a period of service or work after graduation, in return for help in funding college.
- **Repay student loans:** Any outstanding loans should be repaid as quickly as possible.

[1] Federal income tax law does not allow deductions for contributions to "529" plans, although growth inside a plan is tax-deferred and qualified distributions are tax-exempt. State or local tax law, however, can vary widely. 529 plans involve investment risks, including possible loss of funds, and there is no guarantee a college-funding goal will be met. The fees, expenses, an features of 529 plans vary from state to state.

[2] These comments concern federal income tax law; state or local income tax law may vary widely.

529 Higher Education Savings Plan

Federal tax law allows[1] the states to establish tax-advantaged savings programs to pay for a student's qualified higher education expenses. In these programs, cash contributions are made to an account established for a named beneficiary. An investment management firm typically manages account funds. The amount ultimately available to pay for the beneficiary's education depends on growth in the account between contribution and withdrawal. Higher education savings accounts are not insured and losses are possible.

Under federal tax law, contributions are not tax deductible and any growth in an account is tax-deferred. Distributions used solely to pay for qualified higher education expenses are federally tax-exempt. State or local law, however, can vary widely; contributions may or may not be tax deductible, and distributions may or may not be tax exempt.

Key Definitions Under IRC Sec. 529

- **Qualified higher education expenses:** Generally, tuition, fees, books, supplies, and equipment required for attendance qualify. Reasonable costs of room and board are also included if the student is attending school at least half time. Additionally, qualified higher education expenses include costs incurred to allow a special needs beneficiary to enroll at and attend an eligible institution.
- **Eligible educational institution:** Accredited post-high school educational institutions offering associate's, bachelor's, graduate level, or professional degrees typically qualify as eligible. Certain vocational schools are also included.

Contributions

Contributions to a savings plan must be in cash and may not exceed the amount necessary to provide the beneficiary's qualified higher education expenses. Program sponsors will specify the maximum allowable contribution. In many programs, more than $250,000 may be contributed for a single beneficiary. While some donors contribute lump-sum amounts, many 529 savings plan accounts are set up with automatic monthly payments. Other considerations include:

- For federal gift tax purposes, contributions are considered completed gifts of a present interest. Generally, no federal gift tax will be payable if a contribution is limited to the annual gift tax exclusion amount. For 2013, this is $14,000. A married couple can elect to "split" gifts for a total annual contribution of $28,000.
- If a contribution for a single beneficiary in one calendar year exceeds the annual exclusion amount, the donor may elect to treat the contribution as having been made ratably over a five-year period.[2] Thus, for 2013, an individual could contribute up to $70,000 for a single beneficiary in one calendar year. If a married couple elects gift splitting, $140,000 could be contributed.

[1] "529" refers to Section 529 of the Internal Revenue Code, the section of federal law which authorizes these plans. The discussion here concerns federal income tax law. State or local law may differ.
[2] If the donor dies before the end of the five years, a pro-rata portion of the contribution is included in his or her estate. Any amounts in a savings plan when the beneficiary dies will generally be includable in the beneficiary's estate.

- Contributions may be made to both a savings plan and a Coverdell Education Savings Account (Coverdell ESA) for the same beneficiary in the same year.

Distributions

For federal income tax purposes, distributions used to pay for qualified higher education expenses are generally excluded from income if the amount distributed does not exceed the amount of qualified education expenses. If a distribution is greater than the amount of qualified education expenses, a portion of the earnings may be subject to federal income tax and a 10% penalty tax may also apply.

- **Distributions due to the death or disability of the beneficiary, or the receipt of certain scholarships:** The earnings portion of the distribution is taxable as ordinary income to the recipient of the payment.
- **Rollover distributions:** Federal law allows one tax-free transfer every twelve months, from one savings plan to another, for the same beneficiary. Funds may be rolled from a 529 higher education savings plan to a 529 prepaid tuition plan and vice versa. If there is a change of beneficiary within the same family, the rollover must be completed within 60 days or the earnings portion will be subject to tax. If a new beneficiary is not part of the same family as the original beneficiary, the earnings portion of the transfer is subject to current income tax.
- **Other distributions:** If a distribution is made from a savings plan for any other reason, the earnings portion of the distribution is included in the taxable income of the recipient. A 10% penalty tax is also applied against the distributed earnings.
- **State and local law:** State and local law can vary widely from federal law with regard to the income tax treatment of contributions and withdrawals.
- **Coordination with other programs:** A beneficiary may generally also claim either the American Opportunity Tax Credit[1] or Lifetime Learning Credit (not both in the same tax year), receive a distribution from a Coverdell ESA, or claim the tuition and fees deduction, as long as the qualifying educational expenses are not the same.

Higher Education Savings Account Characteristics

There are a number of account characteristics that a donor should clearly understand:

- The beneficiary must be identified at the time an account is created.[2] The account owner is usually the primary contributor. However others, such as grandparents, may also contribute.
- The account owner may change the beneficiary. If the new beneficiary is a member of the same family,[3] there is generally no current federal income tax liability.

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[1] Or its predecessor, the Hope Scholarship Credit.
[2] An exception exists for organizations accumulating funds for future scholarships.
[3] Generally, siblings, children, grandchildren, parents, grandparents, nieces or nephews, uncles or aunts, their spouses, and first cousins are considered members of the same family.

529 Higher Education Savings Plan

- Amounts accumulated in a savings plan operated by one state generally may be used at educational institutions in a different state.
- A higher education savings plan involves investment risk, including the potential to lose money.[1] Contributing to a higher education saving plan does not ensure that your college funding goals will be met. Further, there is no guarantee that a beneficiary will be admitted to college.
- Under federal law, neither the beneficiary nor the account owner is permitted to direct the investments in the account. Account owners may, however, choose among broad investment strategies established by the program sponsor. A change in investment strategy is generally permitted once each calendar year, or when a new beneficiary is named.
- Most 529 savings plans require that funds contributed for a beneficiary from a custodial account become the property of the beneficiary when the beneficiary reaches his or her majority. A custodial account is one set up under the Uniform Gifts to Minors Act (UGMA), the Uniform Transfers to Minors Act (UTMA), or the local state version.

Other Issues to Consider

- **Home State Plans:** The fees, expenses, and features of higher education savings plans vary widely from state to state; some states have more than one plan. Consider whether the plan in your (or the beneficiary's) home state offers any tax or other benefits that are only available to participants in that particular state's plan.
- **Effect on financial aid:** Assets in a 529 savings plan are considered in the "Expected Family contribution" calculations. Tax-free distributions from a 529 savings account (those used to pay for qualified education expenses) are not counted as income to either the parent or student in the financial aid determination process.[2]

Internet Resources

- **The College Board:** http://www.collegeboard.org
- **FinAid! The SmartStudent® Guide To Financial Aid:** http://www.finaid.org
- **College Savings Plan Network:** links to state-run web pages on prepaid tuition or college savings plans, at: http://www.collegesavings.org
- **U.S. Department of Education – student aid website:** http://www.studentaid.ed.gov/

Seek Professional Guidance

Individuals considering a higher education savings plan are faced with a number of income, gift, estate tax, and investment questions. The guidance of appropriate tax, legal, need-based student aid, and financial professionals is highly recommended.

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[1] If certain requirements are met, a complete loss in a 529 plan account may be deducted on your federal income tax return as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit. See IRS Publication 970 for details. State or local law may vary.

[2] See the U.S. Department of Education "Dear Colleague" letter of January 22, 2004, GEN-04-02.

Education Savings Plans Compared

Benefit or Feature	"529" Prepaid Tuition Plan[1]	"529" Higher Education Savings Plan[1]	Coverdell Education Savings Account
Basic concept	Buy tomorrow's tuition at today's prices.	Tax-advantaged savings account to accumulate funds for higher education.	Tax-advantaged savings account to accumulate funds for education.
Federal income tax treatment	Contributions are not deductible; growth is tax-deferred; withdrawals for qualified higher education expenses are exempt from tax.	Contributions are not deductible; growth is tax-deferred; withdrawals for qualified higher education expenses are exempt from tax.	Contributions are not deductible; growth is tax-deferred; withdrawals for qualified education expenses are exempt from tax.
State or local income tax treatment	Varies. Some states follow federal income tax law, while others do not.	Varies. Some states follow federal income tax law, while others do not.	Varies. Some states follow federal income tax law, while others do not.
Level of investment risk	Generally a low level of risk. Sponsoring state or organization typically promises to invest funds to match tuition increases. Later contributions may be required.	Varies, depending on the underlying investments. An investment manager typically manages the funds. Both gains and losses are possible.	Varies, depending on the underlying investment. A wide range of self-directed investments is available. Both gains and losses are possible.
Where to purchase	Directly from the state or private institution involved.	Investment brokers, banks, credit unions, insurance companies, or directly from the state involved.	Investment brokers, banks, credit unions, and insurance companies.
Who can contribute?	Generally, anyone. Residency restrictions may apply.	Generally, anyone. Residents in one state can often invest in another state's plan.	Generally, anyone.
How much can be contributed?	Contributions must be in cash and may not exceed what is needed to fund the beneficiary's higher education expenses. The program sponsor will specify the maximum amount.	Contributions must be in cash and may not exceed what is needed to fund the beneficiary's higher education expenses. The program sponsor will specify the maximum amount.[2]	Contributions must be in cash and may not exceed $2,000 per beneficiary per year.
Beneficiary age limits for contributions?	None	None	Before age 18 unless a special needs student.
How are payments made?	In a lump-sum or periodic payments.	In a lump-sum or periodic payments.	Typically, in periodic payments.

[1] "529" refers to Section 529 of the Internal Revenue Code, the section of federal law which authorizes these plans.
[2] In some higher education savings programs, more than $250,000 may be contributed for a single beneficiary.

Education Savings Plans Compared

Benefit or Feature	"529" Prepaid Tuition Plan	"529" Higher Education Savings Plan	Coverdell Education Savings Account
Do income limitations apply to the donor?	No	No	Yes. Contribution is phased out for donors whose AGI exceeds certain limits.[1]
Who controls the funds?	Generally, the donor.[2] If the account is a custodial account, the beneficiary becomes the owner when he or she reaches age 21 (18 in some states).	Generally, the donor.[2] If the account is a custodial account, the beneficiary becomes the owner when he or she reaches age 21 (18 in some states).	Generally, the donor.[2] If the account is a custodial account, the beneficiary becomes the owner when he or she reaches age 21 (18 in some states).
What expenses are covered?[3]	All plans cover tuition and fees. Some plans include a room and board option or allow excess tuition credits to be used for other qualified expenses.	Generally, most costs required to attend a qualified post-high school educational institution. May includes tuition, fees, books, supplies, and equipment as well as reasonable costs for room and board.	A wide range of expenses is allowed, to attend Kindergarten thru 12th grade, as well as post-high school educational institutions. May include tuition, fees, books, supplies, and equipment, as well as reasonable costs for room and board.
What schools may the beneficiary attend?	Prepaid tuition plans typically limit attendance to same-state post-high school institutions.	Funds accumulated in the savings plan of one state may usually be used at institutions of higher education throughout the U.S. Some foreign schools also qualify.	For K-12, any school that qualifies under state law, including public, private, or religious schools. For post-high school, most institutions in the U.S. qualify.
Effect on financial aid?	Generally reduces financial aid. Account owned by student penalized more than parent-owned account.	Generally reduces financial aid. Account owned by student penalized more than parent-owned account.	Generally reduces financial aid. Account owned by student penalized more than parent-owned account.
May account be rolled-over to other family members?	Yes	Yes	Yes

[1] For unmarried individuals, the contribution is phased out when adjusted gross income (AGI) is between $95,000 - $110,000. For married couples filing jointly, the phase-out range is an AGI of $190,000 - $220,000.

[2] With a "529" prepaid tuition plan or a "529" savings plan, if the assets are not used for higher education they may be returned to the donor. In a Coverdell Education Savings Account, if the assets are not used for higher education, they will ultimately become the property of the beneficiary.

[3] Technically, under IRC Sec. 529, the same definition of "qualified higher education expenses" applies to both prepaid tuition plans and higher education savings plans. In practice, however, for prepaid tuition plans, the sponsoring entity will limit the use of the funds to the types of expenses shown above.

How a 529 Higher Education Savings Plan Works

A “529” higher education savings plan is a tax-favored program operated by a state designed to help families save for future college costs. While the fees, expenses, and features of these plans will vary from state to state, as long as a plan satisfies the requirements of Section 529 of the Internal Revenue Code,[1] federal tax law provides tax benefits for both the contributor and the beneficiary.

How Does It Work?

Contributor

Higher Education Savings Plan

- A tax-advantaged account to save for higher education.
- Earnings accumulate tax deferred.
- Does not guarantee admission.
- If a beneficiary does not use funds, a new beneficiary can be designated.

Tax-Free Withdrawals

Taxable Withdrawals

Withdrawals for Education

- Withdrawals for qualified expenses are generally tax-free.
- Qualified expenses generally include tuition, books, fees, supplies, equipment, and room and board.

Non-Qualified

- Any part of a withdrawal that is not applied to a qualified expense is considered non-qualified.
- The earnings portion of non-qualified amounts is taxable and a 10% penalty is generally applied.

[1] Federal law does not allow income tax deductions for contributions to 529 plans, although growth inside a plan is tax-deferred and qualified distributions are tax-exempt. State or local tax law can vary widely. 529 plans involve investment risk, including possible loss of funds, and there is no guarantee a college-funding goal will be met.

Saving for College

Funding a college education for a child is generally the largest purchase a family will make, aside from buying a home. And college is expensive. In 2012, for example, the average one-year cost of tuition and fees, and room and board, at four-year public colleges in the U.S. was $16,789.[1] If this annual figure is multiplied for four years of study, the total reaches $67,156. And that's not everything – these figures do not include books, transportation to and from school, other incidentals, and continuing cost inflation.

Not only is college expensive today, the cost of a college education keeps going up as each year passes. Even worse, higher education costs have been increasing at a rate faster than inflation. The average annual tuition and required fees charged at four-year public colleges in the U.S. in 1985 was $1,228. By 2012 that figure had grown to $7,701[1], a compound annual growth rate of 7.04%. In comparison, inflation, as measured by the Consumer Price Index (CPI-W),[2] increased from 1985 to 2012 by an annual compound rate of only 2.75%. Many expect that college costs will continue to outpace inflation.

Start Planning Early:

With college costs high and rising, a family needs to begin the college planning process as early as possible. Taking key steps now makes it easier to reach the goal:

- **Start a savings program:** Start by estimating the cost of college. Once the cost is known, the needed savings can be calculated. Then compare available cash flow with the savings required. If current cash flow is not enough to save the full amount, at least a partial savings program can be started.
- **Consider tax-advantaged approaches:** 529 Prepaid Tuition Plans, 529 Higher Education Savings Plans,[3] Coverdell Savings Accounts, and cash value life insurance all have important tax advantages.
- **If there's a shortage:** If personal savings will not be enough, the family can plan for the need to apply for financial aid or begin the search for scholarship funds.

Savings Example

Assume a family has a new born child. College costs are currently estimated to be $15,000 per year, and are expected to increase at 6% per year over the next 18 years. The total amount needed at the start of college for four years will be almost $178,000. If the family can earn 3.5% (after-tax) on their savings, monthly deposits of approximately $590 will be needed to pay for the child's education.

[1] U.S. Department of Education, National center for Education Statistics, Higher Education General Information Survey, Table 349, prepared July 2012.
[2] The CPI is the Consumer Price Index for Urban Wage Earners and Clerical Workers.
[3] Federal law does not allow deductions for contributions to 529 plans, although growth inside a plan is tax deferred and qualified distributions are tax-exempt. The earnings portion of a non-qualified distribution is subject to federal income tax, including a 10% tax penalty. State or local tax law, however, can vary widely. 529 plans involve investment risk, including possible loss of funds, and there is no guarantee a college-funding goal will be met. The fees, expenses, and features of 529 plans vary from state to state.

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