An Education About College Funding

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This year my family has faced a big change – the kind of change that every family with children is eventually going to face. Our oldest daughter Amanda went off to college. Aside from that lingering feeling that somebody is missing when we sit down to a family dinner, we had a much bigger dilemma: how we were going to cover the costs in the most effective way possible.

The Plan (When You Haven't Planned Ahead)

Of course we knew for years that we would be facing this day, so it didn't really take us by surprise. And we are fortunate to have the means to cover the bills. But we made the conscious decision not to set aside money in a separate account because the benefits seemed small and there were some associated costs. So the question was whether there was anything we could do to gain an advantage when it was time to pay. There was.

We set up a 529 as a pass-through entity and pay the college from there. Whenever a bill comes due we evaluate which of our investments it makes sense to liquidate and we transfer the money into the 529. For our family the biggest benefit was the $600 credit we got on our New York State income tax. There may be other benefits depending on your family's particular situation.

The Starting Point

We started speaking to our daughter a few years ago about her interests and preferences, and then we visited several colleges that seemed to be a good fit for her and all of her interests. Academically, Amanda is interested in environmental science and wants to become a teacher. A noble endeavor – and one we're proud to support her in – but not one that requires a degree from a particular school. This gave us some budgetary flexibility. We had a very direct talk with Amanda about this and were frank with her about the maximum we wanted to spend. We also encouraged her not to get too caught up in where her friends were going. In considering her choices she also kept cost in mind. She also decided that a smaller school would provide more of the kind of community she needs to thrive. Amanda eventually chose a state school in another state with a moderate price tag and so far seems quite happy there.

Allocating Resources

It is very important to figure out *where* you are going to take the money from to pay for your child's education. There are a whole range of possibilities, each of which has benefits and drawbacks:

Child-owned assets:

Sometimes parents or other relatives create accounts in the child's name to be used for college. In recent years most of the benefits to be derived from this have completely evaporated. There are virtually no tax benefits left to creating a gift account for a child. Beginning in 2008 the income of any child is taxed at their parents' rate for full time students aged 24 and under and for others aged 19 and under.

Additionally, when the college performs an evaluation for financial aid eligibility, assets in the child's/student's name are weighted at a whopping 333% higher than if they were in the parents' names.

Education-specific accounts:

Two different types of education-specific accounts with modest tax advantages have been established by law:

- Section 529 accounts (discussed above) – This can be especially useful for New York State residents. There is an annual maximum contribution of $10,000 for the 529, which is not likely to cover all expenses, but the assets grow tax-deferred.
- Coverdell Education Savings accounts – These work like a Roth IRA in that tax is paid as money is contributed. In tax year 2006 there was a contribution limit of $2,000 per beneficiary per year (this increases slightly every year). However, even this contribution limit phases out as parental income increases to $95,000 for parents filing individually or $190,000 for married parents filing jointly.

Both of these accounts will reduce your child's eligibility for financial aid.

Other savings:

You could fund your child's college education from various other savings accounts; however, you should talk with your CPA to review the tax implications. If there are no tax advantages, it is probably worth exploring other options.

Loans:

Borrowing money might make sense for your family, depending on your particular situation and the available interest rates.

- Federal education loans – are available at a fixed interest rate and may carry a $2,500 interest deduction, depending on your income.
- Loans against life insurance – if you design this kind of loan properly, you are borrowing from yourself and your money can grow tax-free.
- Home equity loans – are the funding source of last resort because they do not carry any tax advantages when used for something other than home-related expenses.

THE BOTTOM LINE

Funding a college education is not only more expensive than it used to be; it's also far more complicated. No matter what your income level, you have a range of options, each with its own implications. Be sure to explore them fully with your CPA.

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