Saving for College 101

My wife and I had our first child 8 months ago. With every new milestone she attains, we joke that our "baby" will be leaving us for college shortly. While she won't be packed and ready to go tomorrow, today is the time to start creating a plan to get her there.

The rising cost of higher education is astonishing. Many parents wonder how they will ever be able to afford to send their little darlings off to college. Don't panic! There are some elementary approaches to saving for college that won't have you cramming at the last minute.

One approach which has evolved from Internal Revenue Code Section 529, and is more commonly referred to as "529 Plans," comes in two forms: 1) a prepaid tuition plan; and 2) a savings plan. Although most states have developed their own prepaid tuition and savings plan, we will focus on the Texas plans.

Here's how it works: Typically an account is created by the account owner (usually a parent or grandparent) and a beneficiary of the account is designated (usually a child), meaning that distributions may only be made on behalf of the designated beneficiary.

A key advantage of 529 plans is that all earnings are tax deferred and if distributions from the plan are expended for such plan's qualified expenses, then all taxes on the earnings is avoided. However, if distributions are made for unqualified expenses or the plan is terminated prematurely, then income taxes and applicable penalties and fees will be owed. Also, under Texas law, 529 Plans are protected from creditors.

1) Prepaid Tuition Plan. Texas' plan is called the "Texas Guaranteed Tuition Plan." This Plan guarantees payment of complete in-state tuition and student fees at a junior college or university (provided you have fulfilled your contract). In essence, you are buying future college credit hours at the current year's price, up to 160 credit hours. Your child may choose an in-state or out-of-state school but funds are only guaranteed to cover tuition and fees in Texas. Also, if your child does not attend college or passes away before the funds are used, you may receive a refund for your contribution less applicable fees. Moreover, your funds are invested conservatively so your principal is safe.

Be aware though that you may no longer enroll in the Texas Guaranteed Tuition Plan at this time due to new legislation regarding college and university fees. Check www.texastomorrowfunds.org for more information. For those already enrolled in the Plan, Texas will still honor the contracts. Also, you may not change the beneficiary on a prepaid tuition plan.

2) Savings Plan. Texas recently rolled out the "Tomorrow's College Investment Plan." Unlike a prepaid tuition plan, qualified distributions from a savings plan include not only tuition and student fees, but also books, supplies, equipment, and room and board. Also, where the prepaid tuition plan funds can be used for university or junior college, funds in a savings plan can be used for undergraduate or graduate attendance at any accredited college, most vocational and trade schools, as well as some foreign schools.

The maximum gift an individual can make to a savings plan is $11,000 (a married couple can contribute $22,000). Another advantage built into a savings plan is that you can make five year's worth of gifts at once (i.e. a $55,000 gift for individuals or $110,000 gift for married couples). However, no gifts may be made to that beneficiary for the next five years. This gifting program can be a great estate planning tool for grandparents to make gifts to their grandchildren.

Also, the account holder can change the beneficiary, which can be a huge benefit to families with more than one child by avoiding the need to open a separate account for each child. For instance, a married couple with 3 children can create a savings plan account for the oldest child and after the oldest child finishes college, the beneficiary can be changed to benefit the middle child.

The major disadvantage of the savings plan is that funds are invested in mutual funds creating risk to the principal invested and the uncertainty of gains or losses in the stock market. However, you do have the opportunity to choose from conservative to more risky mutual funds.

Another approach is the Coverdell Education Savings Account, which limits annual contributions to $2,000 per beneficiary so long as the beneficiary is under 18. To be eligible for these contributions, taxpayers' adjusted gross income must be below certain thresholds (single under $95,000 and married under $190,000).

Distributions from these accounts are tax free if the qualified expenses of the beneficiary are greater than such distributions. Qualified education expenses are: tuition, fees, books and supplies, room and board at higher education institutions, and also elementary to secondary schools, both public and private. The advantage of this account is that the funds can be used to pay private school tuition through 12th grade.

If you feel you've missed the bus, there are other routes you can take. Nearly all colleges and universities offer financial aid, work/study programs, grants and scholarships. Talk to a school advisor or financial planner today.

Remember, you can never start saving for college too early – even if she can't tie her own shoes!

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