INVESTMENT OPTIONS FOR FUNDING COLLEGE EDUCATION

One of the biggest challenges for families saving for their children's college education is that there are so many options for saving, and one size does not fit all. Which options are right for you depend in part on the age of your child, family income, potential for financial aid, and the expected cost of college. Here are the major college-savings options to consider.

529 college savings plans – Features of these popular state-run plans include

- Investments grow tax deferred and withdrawals for qualified college expenses are currently free of federal tax through 2010
- Some states give tax breaks on the contributions
- Over $200,000 can be invested in many plans, and as much as $110,000 at one time
- Investor retains control and can change beneficiaries
- No income restrictions
- Their impact on financial aid is smaller than many alternatives

While 529 plans can be an especially good alternative for high-income families wishing to save a substantial amount for college, investment options usually are limited, and management fees are sometimes high.

Coverdell education savings accounts – You can contribute up to $2,000 a year per child, but there are income restrictions ($190,000 for married couples). Earnings are federal income-tax exempt if used for qualified education expenses, and unlike 529 college savings plans the tax break is not scheduled to end by 2011. Coverdells offer many more investment choices than 529 plans, and often have lower expenses.

Coverdells can be a good option for people who can save only a small amount each year, or who may want to fund a Coverdell before moving on to other alternatives. Their impact on financial aid is now the same as that of 529 plans—the account is considered the parent's asset instead of the student's, resulting in more aid.

Pre-paid tuition plans – Under these plans, you can buy part or all of a school's future tuition bill at today's prices. Once offered only by some states, a coalition of nearly 200 private schools now offers prepaid tuition plans through a program called Independent 529 Plan. Earnings from either private or public plans are tax exempt.

It's a good option for conservative investors who want to lock in tuition costs and who know what college their children will likely attend (there are penalties for changing your mind about a state school, but there's more flexibility under the private plan). Also, under current rules, prepaid plans reduce financial aid dollar-for-dollar.

Custodial accounts – Investments are held in the name of a minor, but are managed by the custodian (such as a parent). This arrangement provides some tax benefits, especially for higher-income families because they shift capital-gains taxes to their lower-income children. Unlike some other college funding alternatives, there are no income restrictions. But contributions over $11,000 a year per parent are subject to gift tax, and the assets remain in the parent's estate in some instances.

Custodial accounts present three major drawbacks. One, the gifts are irrevocable. Two, the child assumes control of the assets when he or she becomes a legal adult, and thus may spend the money elsewhere besides college. Three, the assets typically count more heavily against financial aid, though some colleges are changing their policies in this area.

Series I and EE savings bonds – The interest earned from these bonds is free of federal tax as long as it is used to pay for tuition and fees, the parents hold the bond title, and parental income isn't too high. But the benefits may be reduced by other education tax breaks such as the HOPE Scholarship.

Taxable investments in the parent's name – The advantages include nearly unlimited investment options, no income restrictions, retention and control of the assets, and the flexibility of using the assets for something other than college if necessary. The major disadvantage is the taxes on earnings. You can minimize that by gifting the assets to your child when it's time for college and having them sell the assets, though you could face *gift* taxes.

Individual retirement accounts – Money taken out of a traditional IRA is free of the ten percent early withdrawal penalty (but not ordinary taxes) if it's used for qualified education expenses. Withdrawals of Roth IRA contributions are tax free, and even the earnings may be tax free in some situations.

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