GET A CLUE ABOUT College Savings Plans

With education costs rising, your kids' future can't start too early

BY KARIN PRICE MUELLER AND ALLYSON MURPHY
THE STAR-LEDGER

Think it's hard to get into Princeton? Try paying the tuition bills. For the 2006-07 academic year, the average annual cost for a four-year private school was $30,367, including tuition, fees, room and board, according to the College Board. Four-year public schools averaged $12,796 for in-state students. Here's a primer to help you make the most of your college savings.

OUR EXPERTS:

Christopher Cordaro, certified financial planner, RegentAtlantic Capital, Chatham

Vince Pallitto, certified financial planner and certified public accountant, Summit Asset Management, Florham Park

Marnie Aznar, certified financial planner, Aznar Financial Advisors, Morris Plains

Nick Spagnoletti, certified financial planner, MACRO Consulting Group, Parsippany

What are 529 plans?

529 plans aren't brand-new, but they're without a doubt the hottest savings vehicle for college. Money invested in a 529 plan grows tax-free, and as long as you use the funds for qualified education expenses, you'll never pay taxes on the earnings.

"529s are the greatest college savings vehicle ever created," Cordaro says.

Two types

529s come in two varieties. The most popular, 529 Savings Accounts, are offered by individual states. You can choose from a menu of investment options within the plan, similar to a 401(k)'s choices. Many states allow residents to deduct contributions, but New Jersey doesn't offer that benefit. It instead offers a tax-free scholarship of up to $1,500 if the student attends a New Jersey school. You don't have to be a resident of a particular state to invest in its plan, but you can only take the state tax deduction if you live there.

The second type of 529, a pre-paid tuition plan, allows you prepay for college. You essentially lock in today's tuition rate for a particular college, and when your child attends in the future, you'll avoid college inflation.

Benefits

You can save more in 529 plans than in any other college savings vehicle. The contribution cap varies by plan, but you can save more than $200,000 in most plans.

529s also offer flexibility. If the beneficiary of your plan, say, your eldest child, decides not to go to college or receives a full scholarship, you have options.

"They allow the donor to keep control over the assets because the named beneficiary has no rights to the funds," Pallitto says. "You can change beneficiaries or even reclaim the assets."

And unlike IRAs and Roth IRAs, everyone is eligible to participate, regardless of their income level, Pallitto says.

529 accounts are considered the asset of the owner rather than an asset of the beneficiary for financial aid purposes, Aznar says. Under the federal financial aid formula, 5.65 percent of a parent's assets are considered to be earmarked for college, rather than 20 percent of a child's assets. (Before July 1, child assets were assessed at a rate of 35 per cent.) By naming yourself owner of the account, your child may be eligible for more aid.

How much you'll need

The advantage of starting early

Starting early can make a big difference when it comes to saving for college. The earlier you start, the less you'll have to save, because your money has more time to compound.

Here's a look at how much you'll have to save to cover the entire cost for your future college student. Keep in mind changes in college inflation and your rate of return will have a big effect on the numbers. (Visit FinAid.com's Savings Plan Designer calculator to run your own numbers.)

Costs to fully fund a four-year college education

NEWBORN	Private school	Public school (in-state)
Current One-Year Costs:	$30,367	$12,796
Cost Inflation Rate:	7.00%	7.00%
Years to Enrollment:	18 years	18 years
Projected Total Costs:	$455,708.66	$192,025.82
Interest Rate on Savings:	8%	8%
Savings Interest Compounding:	Monthly	Monthly
Contribution Frequency:	Monthly	Monthly
Contribution Amount:	$942.94	$397.33

10-YEAR-OLD	Private school	Public school (in-state)
Current One-Year Costs:	$30,367	$12,796
Cost Inflation Rate:	7.00%	7.00%
Years to Enrollment:	8 years	8 years
Projected Total Costs:	$231,659.18	$97,616.19
Interest Rate on Savings:	8%	8%
Savings Interest Compounding:	Monthly	Monthly
Contribution Frequency:	Monthly	Monthly
Contribution Amount:	$1,719.04	$724.37

Bonus clue

"If there is a choice between the two, save for retirement. You can find other ways to pay for college, but you can't find other ways to fund your retirement."

VINCE PALLITTO,
CFP and CPA, Summit Asset Management

Help is available online

FinAid.com: Learn the ins and outs of financial aid and more.

CollegeIsPossible.org: The American Council on Education's K–16 youth development program has the goal of motivating students from underserved communities to seek a college education.

SavingForCollege.com: A comprehensive resource to compare 529 plans

CollegeBoard.com: A not-for-profit association offering comprehensive college information

FastWeb.com: Huge free resource for scholarships, boasting more than 1.3 million scholarships worth more than $3 billion

How to choose a 529

Where to invest?

There's a huge menu of plans to choose from. Some states offer prepaid tuition plans, some offer savings plans (or more than one savings plan) and some offer both. But they're not all the same.

Here are some questions to ask:

- What's the fee structure?
- What investment company manages the plan?
- What are the minimum and maximum contributions?
- What are my investment choices?
- Are there state residency requirements?

The plans with the lowest fees tend to be those managed by no- or low-load mutual fund companies, such as the Vanguard Group or TIAA-CREF. 529s managed by fund companies that charge loads generally have higher overall expenses.

Online resource

To compare expenses and other plan features, the best resource is the Web site SavingForCollege.com. It has a tool that allows you to compare plans side-by-side, tremendously cutting down your research time.

How to invest

The best 529 plan investment choices are age-based allocations, Cordaro says. As the child gets older and is closer to entering college, the investment company automatically changes the asset allocation from higher-risk equities to lower-risk fixed income.

"Most people are too busy, and remembering to adjust the asset allocation is the last thing they are thinking about, right after changing batteries in smoke detectors and changing their oil," Cordaro says.

529 alternatives

Coverdell Education Savings Accounts (ESAs)

Coverdell Education Savings Accounts allow you to save tax-free, but they're more limited than 529 plans. You can only save $2,000 per year per beneficiary in a Coverdell, and that's only if you meet the income requirements.

Eligibility for a married couple filing jointly is phased out when their modified adjusted gross income is between $190,000 and $220,000, and a single filer is phased out between $95,000 and $110,000.

If you do qualify, one advantage of Coverdells over 529s is that you have the freedom to invest in almost anything, while a 529 plan is limited to the investments offered by the plan you choose, Spagnoletti says.

Cordaro calls Coverdells a distraction, despite the investment flexibility.

"Because you can only contribute a small amount, it is harder to achieve investment diversification. You could more easily achieve diversification with the 529 limits," Cordaro says.

Pallitto also isn't a big fan because of the small contribution limits, but he notes you can use Coverdells to pay for elementary and secondary education, whereas a 529 is only for post-secondary education.

Custodial accounts

Parents used to love stashing college money into Uniform Gift to Minor (UGMA) or Uniform transfer tso Minor (UTMA) accounts because of their tax advantages. The first $850 of earnings is tax-free, the next $850 is taxed at the child's rate and any earnings over $1,700 are taxed at the parent's rate.

But with the tax-free status of 529 plans and Coverdells, these custodial accounts are losing favor.

One reason custodial accounts aren't drawing in the dollars is the child is the owner of the account. At the age of majority, 18 in New Jersey, they can spend the money on anything they want.

"If your child decides that the best use of the funds is a brand new Harley-Davidson and a trip around the world, legally there is nothing you can do to prevent it— except gently explain to them that they can have the Harley now and NO inheritance later!" Aznar says.

If you have college money in custodial accounts already, you can move it into a 529 plan and benefit from future tax-free growth. Still, there will be a tax bill today.

"Be careful to check the cost basis on the investments that you have in the UTMA," Cordaro says. "They will have to be sold and cash contributed to the 529. If you have done well in UTMAs, that could mean some large capital gains taxes to pay."

But you'd have to pay those taxes eventually when you pull funds out of the custodial account to pay for college, Cordaro says.

Tips for late starters

- If you haven't started saving yet, or if you haven't saved much, and Junior is only a few years from college, it's never too late to start.
- Even if you don't have much time left, sock away whatever you can into a 529 plan or shift taxable assets into a 529. "If you had $100,000 saved for college in a taxable money market, moving to a 529 could save you around $2,000 a year in taxes," Cordaro says.
- Don't be afraid to investigate college loans, which offer favorable terms.
- Check your credit now so you can clear up mistakes before you start applying for loans.
- Establish a home-equity line of credit, so it can be ready in case you need to borrow for tuition bills.
- Research scholarships now so you don't miss any important deadlines. Even if your student isn't a star athlete or an academic champ, there may be free money out there for him. Check out FastWeb.com for available scholarships.
- Adjust your long-term budget, Spagnoletti says. "If you're going to need a new car soon, or you're contemplating a similar large purchase, you may want to re-adjust what you were planning to spend," he says.
- Save the extra! "If you get a raise or pay off a loan that involved a regular monthly payment, capture that excess in the form of automatic monthly savings," Aznar says.