Chapter 1

Braving the New World of College Savings

In This Chapter

- Figuring out what and how to save
- Considering Section 529 plans
- Taking a look at Coverdell Education Savings Accounts
- Evaluating other savings options
- Making the most of your savings

You may have just found out that you're pregnant. Maybe you're at the point where the college catalogs are beginning to accumulate on your dining room table. Or perhaps your family is somewhere in the middle, with your children out of diapers but not yet into calculus. Wherever your family falls in the age spectrum, one thing is certain: either in your immediate family or in your extended one, some people will want to continue their educations beyond that once-adequate but now insufficient stopping point of a high school graduation.

And therein lies a problem: Although your child can receive a primary and secondary education without incurring any added expense in your budget (unless you take into consideration your local parents' group's fundraisers), postsecondary education of any type isn't free for the asking. You must pay for the privilege of having your child attend college. If you've already explored the costs of a postsecondary education, you know that the numbers being discussed are large; if you haven't yet experienced the pleasure, rest assured that the amounts in question will likely take your breath away.

In solving any problem, you need to remain calm and focused on the task at hand. That's where this book may help — by making you methodically look at your lack of college savings, helping you leave your misconceptions about saving at the door, and showing you ways to actually begin saving. After you convince yourself that you're able to save something and you actually begin to put some money away, you've won a major victory; everything that follows will be easier. Just keep in mind that saving now will create opportunities and open doors for your children in the future.

Doing the Numbers

Up until now, crunching the numbers and figuring out what you think college will cost has usually been where you begin and end your exploration of the topic of how to pay for future educational costs. But after you resolve to start saving and you take the projected costs and create a plan to save for that amount, it's time to take this exercise a bit more seriously.

Figuring up the costs

Depending on the size of your family and your expectations, adding up the cost of a college education can be a fairly straightforward calculation, or it may become quite involved.

Be realistic, both about the capabilities and ambitions of your future student and your ability to pay.

Your straight-A daughter may have to scale back on her dreams of MIT if your budget, including amounts that you can add from your current earnings, only goes as far as your local state college (although not necessarily — she may want to seriously consider applying for some scholarship aid as outlined in Chapter 16).

Likewise, there's little point in your saving for an Ivy League education if your child has plans to open his own auto repair shop. And clearly, the more children you're sending to college, the thinner your resources may be stretched per child (although, depending on how closely spaced your children are in age, this situation may actually work to your advantage if you need to apply for financial aid, as can you find out in Chapter 17).

Finding resources to help you save

No matter how late you may begin to save specifically for future college costs, the entire weight of the enterprise doesn't necessarily need to rest solely on your shoulders, nor do you need to begin to save for college from nothing.

Chapter 3 helps you find hidden assets you may have available, to augment your college savings. It may also alert you to other resources you haven't even thought of — family and friends or even the student himself. Just because these are your children, you don't have to come up with the full amount of their college costs from your pockets alone.

Saving efficiently

Too many people equate saving for the future with current deprivation. For most people, living expenses currently equal, or even exceed, income, and they may not have money left over in the family budget for saving. Clearly, if you fit into this category, you're not going to be able to save unless you make some changes in your life. And although I would never advocate giving up your morning coffee and sticky bun every day as a savings technique, Chapter 4 shows you some relatively painless adjustments that will maximize the amount of money you can shave from your current budget while minimizing the effect on your life.

Exploring Section 529 Plans

Saving money is a good thing, or so the federal government would have you believe. Uncle Sam is prepared to back up that philosophy with a variety of savings programs that contain built-in tax incentives, some of which you may already be using (tax-deferred retirement plans, anyone?). One of the newest types of incentive savings plan is the Qualified Tuition Program, or Section 529 plan, which is designed solely for the purpose of saving for college or any other type of qualified postsecondary education, either tax exempt or tax deferred, depending on a number of factors. Like almost everything else the government cooks up, though, Section 529 plans aren't as simple to navigate as everyone selling these plans would have you think. Chapter 5 gives you the tools you need to understand how these accounts work and how you can best make them work for you.

Following the rules

Section 529 of the Internal Revenue Code is long, complex, and not for the faint of heart. Still, savings accounts that fall under its regulations can be a fantastic way to save for future educational expenses. To make it work, though, you have to understand its requirements; there's little point in setting up one of these accounts if you don't cross your t's and dot your i's just like the IRS wants. Remember, the IRS doesn't have a category of "close, but no cigar." Your account will either qualify under the regulations for tax deferrals or exemptions, or it won't. And if it doesn't, the consequences may be costly.

Making your money work for you

Creating a successful savings plan involves more than following the rules, although compliance with the rules is a big part. Chapter 6 shows you how to actually begin saving money and then put those savings to work for you.

You're a big factor in determining whether your savings program flies or falls. Your understanding of the various ways your savings may earn money and of the different investment options available to you is an important piece of creating the substantial amount of savings you'll need to see your children through college.

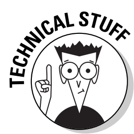
Choosing the best options

Even when you understand the rules, manage to regularly save major portions of your income, and discover how to manipulate the investment choices to your best advantage, events in your life may require you to make sudden changes in your Section 529 plan savings accounts. Life happens, whether you're prepared or not, and often the last thing you want to think about when it does is the effect on your investments. Chapter 7 alerts you to some planning opportunities you'll have with your Section 529 plan accounts and how to make corrections to your college savings when your life doesn't exactly follow the course you originally laid out.

Checking Out Coverdell Accounts

If the world of tax deferred/tax-exempt savings accounts were an ice cream parlor, Coverdell Education Savings Accounts (ESAs) would be a new and improved flavor, still not everyone's favorite, but just what you may want on a particular day. And, not surprisingly, many people, when shopping for a place and a way to save money for college, prefer Coverdell accounts, whether for their wider range of investment options, the account owner's increased level of control over the account, or the fact that certain expenses qualify for tax exemption under Coverdell rules that aren't under Section 529 requirements. Whatever your reasons, Coverdell ESAs may be just the flavor of account you want today.

Understanding the rules and regulations



Code Section 530, covering Coverdell ESAs, follows hot on the heels of Code Section 529 (those government sorts are sticklers for going in order). In it you find all the rules, regulations, and other assorted gobbledygook that govern these sorts of accounts.

But you don't have to mess with the Internal Revenue Code. In Chapter 8, you discover what rules you need to know to open an account, save money inside an account once it's been opened, and then make distributions from the account, tax-free or tax-deferred (depending on a number of factors), for qualified educational expenses.

Getting the most from your Coverdell account

You've probably discovered by now that successful savings involve far more than sticking your money in a passbook savings account at your local bank. And, while your investment options are seriously limited inside a Section 529 plan, you have far more latitude in investment decisions when you open a Coverdell ESA. In Chapter 9, you explore where you can open an account, what information you need to open that account, what sorts of investments you can put into an account, and how to decide what sorts of investments work best for you. Finally, you look at the nuts and bolts of what happens when you begin to make withdrawals from your student's Coverdell account to pay for qualified educational expenses.

Seeing if Coverdell accounts work for you

Saving now for future college expenses may seem like a no-brainer to you, but negotiating the ins and outs of any tax-deferred/tax-exempt savings plan isn't quite so simple. And, not to put too fine a point on it, Coverdell ESAs, while a valuable weapon in the arsenal of college savings accounts, may not be the right choice for you. Chapter 10 gives you some insights into what's involved in effectively managing a Coverdell account for your student and what pitfalls to avoid. Finally, if despite your best efforts you unintentionally land in a pile of muck, you find some strategies here to turn lemons into lemonade and perform some damage control.

But Wait! There's More!

People went to college long before there was an Internal Revenue Code, and parents and grandparents saved for college costs even when tax deferrals and/or tax exemptions weren't around. You can save money in lots of other ways, some of them even specifically for college. Even though they may not be as tax advantageous as Section 529 plans and Coverdell ESAs, they may make perfect sense in your overall savings plan. And if you're not able to save enough to cover the full cost, all is still not lost: Various scholarships, grants, and loan programs are available to cover any shortfall you may have between what you've saved and the cost of your child's education.

Rediscovering U.S. Savings Bonds

Whether you're able to save only relatively small amounts, you're uncertain about your potential student's future plans, or you love the safety and security found only in U.S. Savings Bonds, you may find that this is an attractive way to save for future college expenses and still take advantage of some tax exemptions on the interest earned on your bonds. Chapter 11 explains how you may be able to use certain U.S. Savings Bonds to pay at least some of your child's postsecondary educational expenses tax-free. It shows you who may invest, how you may invest, and how to allocate and report your earnings, both taxable and tax-exempt, when you redeem your bonds.

Saving for college the old-fashioned way

It may seem strange to even think this, but the trade-off for taking advantage of the income tax breaks available through Section 529 plans and Coverdell ESAs is that you're guaranteeing that you will use that money to pay for qualified educational expenses. If only all of life were so certain and so sure.

Many of you may be hesitating over how much to save in these plans, or whether to save at all, because of your great uncertainty over your child's future plans. When you save in traditional investment and savings accounts, you eliminate that uncertainty because you're not tied to using your savings in any one way. Of course, in exchange for that freedom to spend your savings as you will, you lose any opportunity to defer or exempt tax on your earnings, but if your world is an uncertain place, you may find that's a small price to pay.

In Chapter 12, you find out about different types of investment accounts, different options of account ownership and their consequences, ways to invest and manage a personal investment account, and, finally, the taxation of investment income.

Putting your faith in a trust fund

For most people, the phrase "trust fund" brings to mind visions of great wealth and privilege; in other words, it has nothing to do with you. And that picture couldn't be further from the truth. If you save money in any form, then you're a potential candidate to create and fund a trust. Chapter 13 explores some different types of trusts and explains why a trust may actually make sense for you in a college savings context.

Saving in your retirement accounts

Using retirement funds to pay for college probably isn't the best way to put money away for college. In certain limited circumstances, however (such as when parents are older or you face completely unplanned educational expenses), it may make some sense to access funds from a retirement account to pay qualified educational expenses. Chapter 14 explains the tax consequences when you use so-called retirement savings to pay for educational expenses, and it alerts you to some major considerations you need to factor into your decision.

Accessing your home equity

If you (or you and the bank) own your own home, you may be sitting on a larger nest egg than you ever considered. A combination of rising home values and shrinking mortgage loan balances has created a large pool of equity for many people, equity that may be made available to fund educational expenses. Chapter 15 illustrates how you may use your house to help put one or more children through college.

Identifying sources of free money

TIP

Not every potential student is an academic genius or a future first-round NFL draft pick, but you don't necessarily need to conclude that your child won't qualify for scholarships and grants.

Chapter 16 describes many sources of outright scholarships and grants. Some of them carry no strings whatsoever for your student (other than actually attending college), and others require some sort of payback, either upfront or after your child completes his education.

Borrowing to fill in the gaps

You're obviously reading this because you don't want to have to resort to borrowing money to pay for your children's college costs. And hopefully, you'll never have to touch the pages of Chapter 17. Still, if you do, it's not the end of the world. This chapter explains what types of financial aid are available and assesses the costs. It also peeks at some of the benefits and the downsides of borrowing money for college.

Maximizing Your Savings, Minimizing Your Tax

This book is, at its heart, about successfully saving and investing money for future college costs on the one hand and paying little or no tax on the other. And if that were the beginning and end of the matter, you'd be looking at a fairly straightforward task, one in which, if you followed all the rules, you'd achieve the desired result at the end of the game.

Unfortunately, you don't live your life in a vacuum, and many forces impact your ability to save adequately, to achieve reasonable investment returns on your savings, and to limit the amount of income tax you'll pay on those investment returns. You're operating on a field that is rarely level and that shifts and shimmies through no fault of your own. As a result, you need to be aware of how large and small changes, whether they're a result of government policy, market forces, or changes in your family's projected college cost needs, will affect your savings programs. And you need to be prepared to move with those changes — to adjust your savings programs to account for these other factors.

REMEMBER

At the end of the day, your success will depend not only on how often you make deposits into your college savings plans or how large the deposits are but also on how well that money works for you. Your goal is not achieving a large balance in one or more college savings accounts. Your goal is watching your children begin their adult lives with good educations, marketable skills, and no college debt.