

A quick look at...

SAVING FOR COLLEGE

Warning: never save for college at the expense of your retirement! You are going to be retired longer than your kids are in college (hopefully). They can borrow for college at advantageous tax-deductible rates, but *you cannot borrow to fund your own retirement.*

Assuming you are already putting money away for your retirement, how can you also save effectively for college? The most obvious way is to put money into a **Regular Savings Account**. These accounts are good if college is less than two or three years away because you will need to keep your savings safe and easily available. If college is further off, passbook accounts are not good due to their low rate of return and because you owe tax on the interest earned annually.

For long-term saving a **Tax-Advantaged Plan** is a better option. These plans allow you to shelter your money from annual taxes, which leaves more of it to earn interest each year. Many of these plans also allow you to withdraw savings tax-free when paying school expenses. Some Tax-Advantaged plans are limited to education funding while others are not so constrained.

Education Plans are designed to fund education tax-free—but if you spend this money on anything else, you will owe income tax and a ten percent penalty on the amount withdrawn.

- **(Coverdell) Education Savings Account.** You can contribute \$2,000 annually to a Coverdell account until the beneficiary is age 18. The money grows tax-free within the account and withdrawals for education are tax-free. The Coverdell is unique because you can withdraw money for any level of education: primary school through college. Furthermore the money can be spent on a far wider range of items than other plans allow. For example, you can pay for computers, tutoring, uniforms, even school transportation. You might want a Coverdell just to cover education expenses other programs will not cover. Note, however, that if you are going to use several education savings programs you must carefully coordinate the benefits so all withdrawals remain tax-free.
- **Qualified Tuition Programs (“529” Plans).** Each state has its own plan and you can usually buy into any of them. If you buy into Ohio’s plan (or most any other state’s plan) and your child goes to college outside of the state, withdrawals are still tax-free. Each plan is different, however, so investigate carefully. For example, Ohio’s plan requires that the donor or beneficiary be an Ohio resident when the account is established. Other states have no residency requirement.
 - **Ohio’s CollegeAdvantage plan** allows you to invest with a state-selected mutual fund company. Your money grows tax-free and withdrawals for college are tax-free. There is no limitation on how much money you (or anyone else) can annually contribute. The only cap is on the total account value (contributions + interest; currently \$331,000).

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Furthermore, you are allowed a \$2,000 annual Ohio tax deduction on money put into the program. If you put in \$5,000 one year, you take a \$2,000 Ohio tax deduction that year, \$2,000 the next year, and \$1,000 the third year. If your child gets a scholarship and does not need all the money, you can change beneficiaries.

Other Plans can be used to fund education, though this is not their designed purpose. Still they offer some nice options because the savings are not restricted to education. If you don't need the money to fund college, it can be used for something else without paying a penalty.

- **Custodial Account.** This is legally a gift to your child. The money belongs to him or her, but you control the account. Anyone can set up a custodial account or contribute to one. You must realize, however, that this is your child's money, not yours. It must—by law—be spent for the child. You cannot buy yourself luxuries with it or even use it to shingle the house. Furthermore, your child gets control of the money at 18 or 21 (depending on state law). Then Junior is free to buy a shiny Harley-Davidson and wave goodbye to college. On the other hand, before your child is an adult, you can spend the money on anything that benefits the child: summer camp, braces or a drum set (Oh joy!).
- **U.S. Savings bonds.** If you cash out savings bonds to pay for college, the interest is tax free—but you must be careful. The bonds cannot be in the child's name (the owner must be a parent over age 24 when the bonds are bought) and the money can only be spent on tuition and fees, no other expenses are allowed (such as room and board or textbooks). Furthermore, if you earn a lot of money (in 2009 over \$134,900 for a married couple), you lose this option. Still, having the security of savings bonds and tax-free interest is a good deal for many middle-income families. And as long as Junior doesn't need the money, you have a tidy emergency fund.
- **Individual Retirement Account (IRA).** Yes, I know I said you should fund your retirement first, but if you must tap into your IRA, there are some advantages. If you withdraw money from a traditional IRA for college, you do not pay the standard 10% penalty for an early withdrawal, though you still owe income tax on the amount withdrawn. If you withdraw money from a Roth IRA, there is no 10% early withdrawal penalty and income tax applies only to interest earned, not to the original amount contributed. (NOTE: if you only withdraw your contributions, there are no taxes at all.) The money withdrawn can go towards the usual tuition and fees, and also toward books, supplies, and if your student is attending college at least half-time, you can even apply withdrawals toward room and board.

Remember this is a general overview. These plans have restrictions based on your income and there are limitations on using several programs simultaneously. If you have any questions, please contact me at **614-263-3900** or **Rob@Reedplanning.com**.

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