# How Best to Fund a College Education

BY RICHARD DEFRONZO

The cost of funding a college education continues to rise. The cost of a college education has continued to rise at a rate greater than general inflation or CPI. With these continued spiraling costs, the question is, what is the best way to provide for a college education? Mutual funds, government bonds, qualified retirement plans, educational IRAs and Section 529 plans are the most common funding vehicles. Each of these tolls has its own tax and economic advantages and disadvantages.

Families who choose to invest in mutual funds do so because they feel that they receive professional management and that it gives them diversification, which protects them from substantial loss. There are no limits on the amount they can invest. Although these might be sound economic reasons for investing in mutual funds, there are no tax advantages because all the income is taxed currently and the full fair market value of the funds are included in their estates for tax purposes.

Federal Series EE&I Bonds are another common investment vehicle because of their obvious security and tax advantages. The income from these bonds is tax-free for state purposes. For qualified taxpayers, the income is fully or partially exempt for Federal purposes if used for qualified higher education cost. Federal taxes can be deferred currently on these bonds. Like the mutual funds, these bonds will be included in the owner's estate for estate tax purposes. There is a limit of $30,000 annually that can be invested in these bonds. Since the built in growth rate of these bonds has been substantially less than the rise in the annual increase in college cost, they are a questionable investment in the long term.

Borrowing from one's 401(k) Plan is also popular. Since the funds in these plans grow tax free until paid out to the beneficiary, they have definite economic advantages. If the funds are taken out to fund the education cost, they are not treated as a taxable distribution, hence no income tax. The major drawback is that the borrowings are limited to the lesser of $50,000, or 50% of the fund's balance. Borrowing from one's 401(k) plan would probably be more suitable for funding state tuitions rather than the higher private school tuitions.

Individual Retirement Accounts (IRAs) are also utilized as a college funding mechanism. There are different types of IRAs and they have different tax ramifications and contribution limits. Contributions to a regular IRA are tax deductible if certain requirements are met. The income is not taxed currently but is taxed when withdrawn. The Roth IRA does not provide for a current deduction but the withdrawal of the original contributions and earnings are completely tax-free if taken out after the owner reaches 59½ years of age. The taxpayer must satisfy certain income level requirements in order to be eligible to contribute to a Roth IRA. The current contribution level to the regular and Roth IRAs is $3,000 per year. This will be increased over the next four years to $5,000, exclusive of catch up contributions.

The Coverdale Education IRA is the most attractive IRA because not only are its earnings exempt from tax if used for education purposes, but it can be used to fund education costs from kindergarten through higher education. The funds can also be used for such items as books, supplies and computers. Unlike the previously discussed funding vehicles, the value of this account is not included in the owner's estate for estate taxes. The major drawback to the Education IRA is that its contributions are limited to $2,000 per year, but this low limit still makes it attractive to family members, especially grandparents.

The most popular and advantageous method of funding a college education is the Section 529 Plan. There are actually two types of plans established by Internal Revenue Code §529. One is a prepaid tuition plan and the other is a savings account plan. One or both of these plans are offered by almost every state. The prepaid tuition plan is really a hedge against inflation. It allows you to purchase future credits for the student at today's credit cost. In effect, you are betting that the cost of the future education will grow faster than the invested funds. The tuition savings account functions like any other investment account, except neither you nor the beneficiary control the investments, however you do choose the investment portfolio options. The contributions to these plans are completed gifts and therefore, are covered by the $11,000 annual exclusion. In fact, you can front-load the plan by making up to five years of gifts ($55,000 or $110,000 if married) at one time. There are numerous advantages to these plans, but the primary ones are the aforementioned front-loading, the tax-free status of the earnings, and the tax-exempt withdrawals of the funds if used for education purposes. In other words, you can put the funds in tax-free, they can grow tax-free and they can be withdrawn tax-free. There is a definite estate tax advantage as well, because they will not be included in the donor's estate for estate tax purposes. If the funds are not used for education purposes and are withdrawn by the owner, then they will be taxed at that time and also be subject to a 10% penalty. The cost of the penalty would probably be offset by the benefit of the tax deferral. You can choose the plan of any state; therefore, you should be able to select a group of investments and a portfolio adviser that satisfies your objectives.

These plans are also appealing to older students who choose to return to school after working several years or retired individuals, because they do not have age limits. However, Congress is considering a 35 year age limit as well as penalties greater than 10% for non-educational withdrawals.

It should be kept in mind that these various funding vehicles could also impact your child's ability to receive financial aid because all institutions weigh the availability of funds to the student. That is, funds owned by the parent are treated differently from funds owned by the student. Some of these funding vehicles result in the parent being the owner, while others transfer the ownership to the student. Before making any investment decisions, you should discuss with your financial advisor the complete tax and economic ramifications to you as well as their impact on financial aid.

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