

WHAT IS THE BEST WAY TO SAVE FOR MY CHILD'S EDUCATION?

I am frequently asked "how do I save for my child's education?"

My answer is based on the Education Savings Account (ESA) and 529 plan which qualify for tax free distributions beginning in 2002. Before 2002 the distributions were taxed to the beneficiary for federal purposes. The 529 plans have no income limitations on the contributor.

I offer the following recap of educational funding alternative choices:

USING YOUR OWN INVESTMENTS

Take your after tax dollars and invest those funds to accumulate monies to pay for your child's education. You will pay taxes at your tax rates, which is often higher than your child's. You will, however, retain control over the funds and incur no penalties if you use the funds for your personal reasons. If your child is five or more years away from college you may want to invest in growth stocks or growth mutual funds. If your child is five years or less away from college you should consider high yield money market funds, Treasury notes, certificates of deposit and series EE bonds.

UNIFORM GIFTS TO MINORS ACT (UGMA)

The UGMA was created to structure and facilitate tax-free gifting of money or assets to children. Dividends, interest and capital gain income on these accounts are taxed to your child up to \$1,900 of income. They are taxed at the parents rates over \$1,900 and when the child is 13 years old or younger. Therefore, you can shelter up to \$1,900 of taxable income to the child, at his or her tax rate, until he is fourteen and no limits after the child is fourteen. A disadvantage is the parent loses control of the account after the child reaches eighteen. In such situations I recommend the parent insist such funds be used for education and use the child's future inheritance as leverage.

EDUCATION SAVINGS ACCOUNT

The contribution is not tax deductible but the earnings are tax free if used for qualified educational expenses. The maximum contribution has been increased to \$2,000 in 2002 from \$500 in 2001. The child must be under 18 when the contribution is made and the contributor must have adjusted gross income of less than \$110,000 if single or \$220,000 if married. All funds must be distributed to the beneficiary before he/she reaches 30 years old. The one benefit the Education Savings Account has over the 529 plan is that qualified education expenses include expenses for school including kindergarten through 12th grade plus post secondary schooling. You can fund both an Education Savings Account and a 529 plan for the same beneficiary in the same year.

PREPAID TUITION PLANS

You can invest in a college or university plan by buying tuition credits at today's prices. No matter what happens to tuition rates in the future, the number of semesters or years you have purchased is guaranteed. The size of the payments is determined by the age of the child and the number of semesters you are purchasing. If your child does not go to the college you have prepaid (disability, death and scholarships are exceptions) you will receive back from the school your payments plus half of the investment return. The investment return is taxable for both federal and state purposes. The funding for the prepaid plans is for tuition only, you can't fund for room, board or other costs.

FINANCIAL AID

Most of the financial aid a child may receive comes from the federal Department of Education (www.ed.gov). The financial aid in the form of grants are outright gifts which do not have to be paid back. Loans, however, must be paid back and usually at low interest rates. Some federal grants are the Pell Grant (\$5,550/yr/max), and the Supplemental Educational Opportunity Grant (SEOG) (\$4,000/yr/max). Scholarship and fellowships are awarded each year for students with special talents whether academic, athletic or artistic. Check out www.fastweb.com for a data base of more than 180,000 scholarships.

AMERICAN OPPORTUNITY CREDIT AND LIFETIME LEARNING CREDIT

These two federal tax credits allow you to reduce your income tax dollar for dollar if you qualify: The American Opportunity Credit and the Lifetime Learning Credit. The American Opportunity Credit is a \$2,500 per student credit that is phased out for married filers with an AGI exceeding \$180,000 and \$90,000 for single filers. The credit can be up to 40% refundable and can offset Alternative Minimum Tax. The credit applies to tuition, fees, and materials used for postsecondary education. The Lifetime Learning Credit offers a maximum credit of \$2,000 per tax return. The credit is phased out for married filers with an AGI exceeding \$120,000 and single filers with an AGI above \$60,000. The credit applies to tuition, fees, and materials used for post secondary education as well as courses to improve job skills.

SECTION 529 PLANS

Please see the summary for details on section 529 plans.