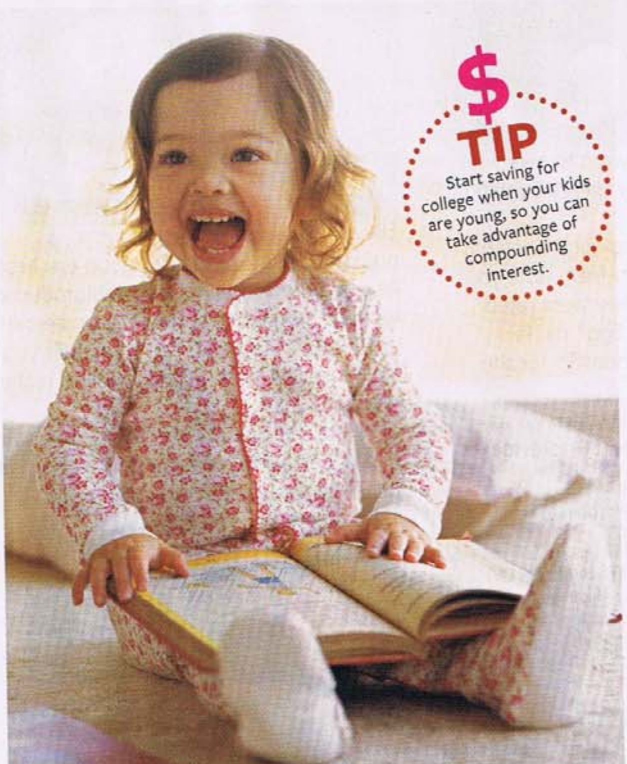
College Saving Savvy

By the time your baby turns 18, you can either send her to college or buy a small island. We help you assess your options so you can start saving now. BY JEFF SCHLEGEL

As you watch your toddler read her first book, upside down, thoughts of her freshman year in college may seem hazy. But the sooner you start socking away funds, the better your chances of getting her there. It will cost about $440,000 to send a baby born today to a four-year private college. The tab for a state school is about half that amount.

Though the horizon is distant, when it comes to saving for higher education, time is of the essence: The sooner you get cracking, the lower your monthly payments. For example, a high school senior's parents who started saving when their child was born 18 years ago would've had to save about $245 a month to cover current college costs, according to research from mutual funds provider Fidelity Investments. If they waited until the child was 10 years old, that figure more than triples to $915 a month. "Parents really need to begin saving early and regularly," says Carolyn Clancy, executive vice president at Fidelity's Personal and Workplace Investing Group. Where to start? Plain vanilla savings accounts generally aren't the answer, because they pay low interest rates and withdrawals are taxed. Here, instead, are better bets.



$ TIP Start saving for college when your kids are young, so you can take advantage of compounding interest.

529 PLANS

What are they? Probably the most popular college savings vehicles, these state-sponsored programs allow money to grow tax-free. Plus, withdrawals are exempt from federal taxes (and state taxes in some states) as long as the money goes to qualified educational expenses such as tuition, books and room and board. A stash of $300 a month can turn into $115,000 in 17 years.

Pros Minimum monthly investments are low ($25), and maximum yearly contributions are high ($12,000 for individuals or $24,000 for married couples). If you get a late start, you can make a special lump-sum contribution of up to $60,000 ($120,000 for married couples) to a child's account without gift or estate tax implications.

"The 529 plans provide the most benefits in terms of tax advantages and parental control over the assets," says René Kim, senior vice president at financial services company Charles Schwab, who oversees the company's retirement and education products.

Consistent annual contributions begun early should pay impressive dividends over time. "A 529 offers a big advantage because of compounding," says Mark Gleason, senior financial advisor at Wescap Management Group in Burbank, CA. Investment earnings are added to the principal each year, and the continuous compounding of these earnings quickens the growth and value of the 529. "For parents with young children," adds Gleason, "compounding can go on for a long time, resulting in a truly large college fund."

Plus, one of the plans' best features is "age-based" portfolios: They automatically shift from higher-risk, higher-return stocks into lower-risk, lower-return bonds to protect the assets as your child gets closer to college age. This autopilot approach means less investment guesswork for parents who have children in different age groups, says Kim. It's also the option that most investors are choosing, according to Savingforcollege.com.

Cons A problem with 529s is that there are about 100 separate state plans—36 states offer more than one 529 program (Nebraska alone has five plans; Arizona has three). While each program offers stock, money market and bond funds, and they're administered by financial services companies such as Fidelity, Vanguard and T. Rowe Price, not all plans are created equal.

Key things to consider when deciding if these plans are right for your family include whether your state taxes withdrawals or allows tax deductions for contributions. You also want to find a low-cost program (plan costs vary from about .25 percent to more than 2.5 percent). And look for investment flexibility so that you can choose what best suits your style and goals. Since most plans are open to out-of-staters and are good at most postsecondary schools in the country, it really pays to shop around outside of your own state.

COVERDELL EDUCATION SAVINGS ACCOUNTS

What are they? Tax-free withdrawals from a Coverdell can be applied to college and K- through-12 expenses, but otherwise the impact of these accounts is limited. "The only time you want to pick a Coverdell over a 529 is if you can't afford to contribute more than $2,000 per year or if you already know you want to send your children to private or Catholic school," says Jorie Barnett Johnson, a certified financial planner at Financial Futures in Manasquan, NJ.

Pros Earnings are tax-free as long as they're used for qualified education expenses, which can include elementary and high school costs.

Cons The annual contribution limit per child of $2,000 is low. To qualify, your adjusted gross income must be less than $110,000 for a single filer or $220,000 for married couples filing jointly.

CUSTODIAL ACCOUNTS

What are they? Under UTMA (the Uniform Transfer to Minors Act), you can open a custodial account for your child at any bank or mutual fund company. The money can be used in any way that contributes to your child's well-being. If the child is 18 or under, the first $900 of income is tax-free; the next $900 is taxed at the child's rate; additional income is taxed at the parents' rate.

Pros There are no contribution limits, but anything above $12,000 per year per child ($24,000 if both parents contribute) are subject to the gift tax.

Cons Unlike a Coverdell account or a 529 plan, a custodial account is considered the child's asset, which increases its impact on financial aid (federal formulas assess it at a 35 percent rate). That means these accounts are best for families that don't need financial aid. If you already have a substantial amount in a custodial account and think you could get aid, spend down the balance. Remember: Your child gains control of the money at age 18 in most states and can use it for *any* purpose—to pay tuition or to buy a convertible. ■

A+ ONLINE RESOURCES

• FINANCIAL AID FACTS
Go to **finaid.org** for an idea of how much aid your child qualifies for. The site also links to FastWeb, a large scholarship and grant database.

• DOES THIS ADD UP?
The college funding calculator at **webwinder.com/calculators/calc_college.html** will help you determine how much money you need to invest monthly so you'll be able to pay for your child's college education by the time she's ready to start. Plus, the calculator adjusts the future cost of attending college based on your own estimated rate of inflation.

• THE 529-PLAN SKINNY
For more on 529s and other college savings plans, visit **collegesavings.org,** as well as the websites of leading financial services companies that administer plans.

• STATE-BY-STATE FEES
The "Plans by State" section at **savingforcollege.com** allows you to see what savings programs are sponsored by your state and to compare them in terms of fees, expenses, and tax benefits. This is a good source of objective information about 529 plans and other ways to save and pay for higher ed.