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Don't *Panic*– Plan!

A Guide to Paying for College

You've heard repeatedly that the cost of actually attending college gets more expensive every year. Even if your child is still in diapers, it's not too soon to start putting away money each month. The latest figures from The College Board 1999 show that in 20 years, or by the time a newborn is ready for college, it could cost over $300,000 to fund his or her education at a private college and over $125,000 for a public college. Where will you get this money?

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You can formulate a college-funding plan now, especially if your child is young, by regularly setting aside a relatively small amount of money in an investment program. If you're in a higher-tax bracket, tax deferral is another important element, allowing the funds put aside for college to accumulate as quickly as possible. Here are a few options to consider in addition to insured, fixed-rate certificates of deposit.

Mutual funds, particularly those that invest in common stocks, are attractive savings vehicles for parents with longer investment horizons. Mutual funds offer a wide range of investment options with differing levels of risk and potential reward. Once established, additional contributions can be very small.

A **401(k)** or **403(b)** plan through your employer can increase your current tax savings by reducing your taxable income as well as allowing your savings to grow tax-deferred until withdrawal. And your employer may match a portion of your contribution. However, there may be some restrictions on or adverse tax consequences upon withdrawal prior to age 59-1/2. If your plan has a loan provision, you may be eligible to borrow against your vested portion of the plan. Typically, this loan must be paid within five years for a 401(k) plan. The interest

(continued on page 24)

 (continued from page 23)

rate is usually a few points above the prime rate, and while not tax-deductible, the interest you pay is invested in your account.

Variable annuities offer tax-deferred growth potential and often have a wide range of investment options. One potential drawback of an annuity is the 10% penalty tax imposed on the taxable portion of withdrawals of surrenders before age 59-1/2. Therefore, annuities are particularly attractive for older parents and grandparents when the age of the contract owner permits withdrawals without the 10% penalty.

Cash value life insurance combines protection and cash values so it helps guarantee an education fund whether you live or die. The cash value of the life insurance policy accumulates tax-deferred. This money may be withdrawn through policy loans, generally without generating any taxable income under current law as long as the policy remains in effect until the death of the insured. Loans and withdrawals will reduce the policy's cash value and death benefit. Life insurance proceeds are income tax-free. So, even if you're not there to see them graduate, your children can use the policy proceeds to finance their education.

You may also be eligible to contribute funds to an **educational IRA** for the benefit of your child. The contribution is limited to $500 per beneficiary per year and is not deductible. The earnings of the IRA may be distributed tax-free if the funds are used to pay the beneficiary's postsecondary educational expenses. The amount an individual is allowed to contribute is limited or disallowed for high-income taxpayers. The contribution to the IRA is considered a gift to the beneficiary.

Your state may also offer a **qualified state tuition program** that allows you to contribute to an account for the benefit of a named beneficiary. The transfer is considered a gift to the beneficiary subject to gift taxes but you may carry the value of the transfer forward for five years under the Federal Gift Tax Annual Exclusion. You may wish to review the specifics of your state's program to determine if it is a suitable option for you.

Of course, if your child is already approaching college age, you may not have sufficient time to benefit from savings and compounding. You may need to look for immediate funds through financial aid in the form of loans, scholarships or work-study programs. Generally, available funds in the form of grants and loans in 1998-99 were $43,605 based on federally supported programs. But this may not be enough to cover the complete cost. Many students are also taking on several part-time jobs to cover other costs.

Once your child enters school, you may be able to take advantage of one of the credits that are available. Each of these credits is subject to a phase-out for high-income taxpayers.

- **The Lifetime Learning Credit** is available for 20% of the qualified tuition and related expenses that are paid by the taxpayer for the year for himself, spouse or dependents. The maximum credit allowed is $1,000 or 20% of a maximum $5,000 of qualified tuition and expenses. In 2002, this amount is scheduled to increase to $2,000 or 20% of $10,000 of qualified tuition and expenses. The Lifetime Learning Credit is a per taxpayer credit that does not increase with the number of children in school.

- **The Hope Scholarship Credit** is only available during the first two years of college. The maximum credit is 100% of the first $1,000 of qualified tuition and expenses and 50% of the next $1,000 of qualified tuition and expenses. Thus, the maximum credit for 2000 is $1,500.

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For any tax year, a taxpayer is permitted to elect only one of the following with respect to one student, (1) the Hope Credit, (2) the Lifetime Learning Credit or (3) the exclusion for distributions for an educational IRA.

The future promises to be even more difficult in terms of college costs. All the more reason to save and plan today for your children's future. If you save early, you may avoid the need for loans, accelerated college degrees and part-time jobs for your children. The cheapest way to pay for education is saving—not borrowing!