Funding Your Child's Education: Make Your Dollar Stretch Farther
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We are lucky living in the Silicon Valley, surrounded by world-class resources and the opportunity to receive a first rate education. In many areas, the extent of the educational opportunities is a single, local junior college. In the Silicon Valley, however, prospective students can choose from no less than 10 junior colleges. (For a list see: http://www-lib.co.santa-clara.ca.us/teen/univlink.html). We have easy access to the Twin Ivory Towers, Stanford and Berkeley, and one of the highest-rated liberal arts universities in the United States, Santa Clara University (SCU). Additionally, we have two excellent State colleges, San Jose State University (SJSU) and Cal State Hayward (CSH).

But the options don't just end at the traditional colleges. You'll find institutions available nearby that can teach you to become a chiropractor, electrician, chef, computer programmer, technician, mechanic, truck driver, airplane mechanic, pilot, bartender, graphics artist or interpreter. (For a partial list, visit http://www.4education.us/california.htm) The variety of options in the Bay Area is as endless as the diverse mixture of cultures we enjoy. Whatever you want to become, you can learn how here!

Importance of an education

Numerous studies have shown that those with a higher level of education make more money than those without. U.S. Census data shows that over a lifetime those with a 4-year college degree will make almost $1,000,000 more than those whose highest level of education is high school. Level of education can be the deciding factor between two candidates seeking the same job or promotion. I also believe that an education gives the psychological edge of knowing that you are among the top 15% of candidates in the country.

But as most parents will tell you, income is not the motivating factor when investing in a child's education, happiness is. For some, happiness may come from a higher income. For others, rewarding work, travel, making new friends, or gaining new experiences are motivating factors. Whatever the reason, the real benefits of an education can be summed up in one word: opportunity. It's been said that luck is when preparation meets opportunity. If this is the case, children with a higher education are certainly more apt to be "lucky" in life than those without. And as friends or relatives, you have the ability to allow a student to become "lucky" enough to participate in higher education by preparing today.

Higher education: Not just college

As a financial planner, I receive information regularly on the newest state sponsored college savings program or tax-advantaged solution. We've all read about them in magazines, seen the ads on billboards, and Upromise (discussed later) has recently launched a nationwide major television ad campaign. In fact, just today I received a brochure in the mail from the State of California for the "Golden State ScholarShare College Savings Trust".

These efforts have gone far in educating the public about opportunities to save for college. But while raising awareness about opportunities to save for college is a very admirable goal, I think we sometimes do a disservice to a major segment of the population: those who *don't* plan to attend college. I say disservice because it appears that educational funding programs are designed only for children who will attend college, and that is simply not true. For the many children who won't attend college, the same opportunities to learn skills, develop confidence and gain entrée into sought after positions are available through one of the myriad trade schools in the South Bay. And while many of the programs I will discuss later market themselves as "college savings" programs, in reality they are "postsecondary education savings" programs.

Postsecondary education includes many credentialed or trade certified programs in addition to college. For instance, in the California ScholarShare program, a qualified withdrawal can be made for any approved "postsecondary vocational institution". In other words, children who may eventually want to become contractors, mechanics, or landscape architects have the same tax-advantaged opportunities to pay for education as those who will become doctors, lawyers, or financial planners!

I believe that a true craftsman in any profession has greater job satisfaction and personal respect than the average worker. And while becoming a craftsman requires time, dedication, love, and discipline, it starts with education. I encourage any relative of a young child to save, even a very small monthly amount, in one of the programs in this article. Providing the opportunity to become a chef, engineer, mason or accountant is not simply giving a child the ability to make more money, but the ability to realize their dreams.

Prices continue to rise

By now everyone is aware that higher education costs have risen at a staggering rate. In fact, in the past decade, tuition costs for a four-year college have risen almost five times as fast as household income, making it much harder to pay for. Can costs continue to climb this quickly? Yes. But while in the past the largest increase in prices has been in private education, we may now see the costs of public education increasing at a faster rate than private schools.

According to the College Board (www.collegeboard.com), in 2003-2004, 4-year private college tuition rates increased an average of 6%, while 4-year *public* school tuition increased over 14%! Taking a quick tour of my alma mater, SCU, shows that the rapid increase over the past 10 years in tuition prices (combined with an aggressive donation program) has translated directly into better facilities. On the other hand, touring SJSU recently with my brother, a graduate of the photography department, shows that many facilities are outdated and under-funded. With state budget deficits at all-time highs, cuts are being made to education, which accounts for roughly 55% of the total state budget in California. The fact is the cost of attending a 4-year public school is still only a fraction of that of a 4-year private school. At the same time, many facilities are aging, college attendance is up, and resources are being squeezed. For these reasons, I expect public college costs to continue to rise at disproportionate levels to income.

Because of this upward price pressure, we cannot assume attending college will be as easy to accomplish in the future as it is today. While many parents in the past did not feel the need to save for college, because they encouraged students to attend junior and state colleges, those same parents today would be wise to start a savings program as early as possible. And while the costs of saving for higher education has traditionally been shouldered by parents, with the price of higher education rising, grandparents and other relatives should consider contributing what they can towards a child's future education costs.

Current Costs

I am always reluctant to quote the costs of saving for a future education. The costs I read in studies and the actual costs of college are not usually the same because financial aid currently plays such a big part in paying for college costs. (I discuss financial aid later in this article.) So, when I talk to parents, I talk about saving for *some* of a child's education. How much depends on their financial aid calculations and ability to save. However, even the smallest amount saved now will add up over time, and creating a mindset of saving is paramount. So, regardless of ability, I encourage parents to save some amount regularly for education.

Some children, of course, will be eligible for more financial aid than others. Below, I have provided a chart that shows the costs of college (tuition, room and board, books, and fees) and the **monthly** contribution to a tax-advantaged savings plan required to pay for the **full** costs of education. Again, very few parents would be expected to save the full amount. Note that the earlier you begin saving for a child's education, the lower the required monthly payments are.

	Type of College	2-Year In-State Public	4-Year In-State Public	4-Year Out-of-State Public	4-Year Private
	2002-2003 Average Cost	$10,458	$12,841	$19,188	$27,677
Years Until Child Begins College	0	$897	$1,167	$1,744	$2,515
	1	$621	$969	$1,448	$2,088
	2	$482	$836	$1,250	$1,803
	3	$398	$741	$1,108	$1,598
	4	$342	$669	$1,000	$1,442
	5	$301	$612	$915	$1,319
	6	$270	$566	$845	$1,219
	7	$246	$526	$787	$1,135
	8	$226	$493	$737	$1,062
	9	$209	$464	$693	$999
	10	$195	$438	$654	$944
	11	$182	$415	$620	$894
	12	$171	$393	$588	$848
	13	$161	$374	$559	$806
	14	$152	$356	$532	$767
	15	$144	$339	$506	$730
	16	$136	$323	$483	$696
	17	$129	$308	$460	$664
	18	$123	$294	$439	$633
	19	$117	$281	$419	$605
	20	$111	$268	$401	$578

Aid eligibility

Remember that the above chart is showing the full average costs of saving for college, including tuition, room and board, books, and fees. The good news is that most parents are not expected to pay for the entire costs of college. According to the College Board (http://www.collegeboard.com/parents/article/0,3708,715-716-0-21385,00.html):

- A record $105 billion in financial aid is available in 2003-2004 to students and their families, an increase of 12 percent over last year.

- Almost 60% of undergraduate students receive some form of financial aid.

- Almost half of all college students receive grant aid.

- In 2002-2003 grant aid averaged almost $2,000 per student in two-year public colleges, over $2,400 at public four-year colleges, and about $7,300 per student at private four-year colleges.

- About 29 percent of students attending four-year colleges pay less than $4,000 for tuition and fees per year.

- Almost 70 percent of students attending four-year colleges pay less than $8,000 per year for tuition and fees.

These statistics clearly show that schools do not expect most parents to pay the full cost of a child's education. And while education costs are rising, financial aid is helping to compensate. You don't have to feel overwhelmed by the costs of college. If you start saving what you can today, you will be able to greatly help your future student.

(To find information about student aid visit: http://studentaid.ed.gov;
http://www.finaid.org; and
http://www.usnews.com/usnews/edu/college/stepbystep/brief/step4_brief.php;
For a list of scholarship searches, visit: http://www.theoldschool.org
For financial aid calculators see: http://www.finaid.org/calculators/finaidestimate.phtml)

How much should you save?

Rather than asking "How much should I save," a better question may be, "Where should I put my savings?" I always encourage parents to save for retirement first, and education second. I do this because there are simply more options and better flexibility with education planning than with retirement planning. If needed, a student can usually get a student loan, but you cannot get retirement loans.

If you are not sure whether you're saving enough for retirement, consult a professional who can prepare a retirement analysis for you. A retirement analysis gives you a basis for making financial decisions; you can try different scenarios and see how they affect your retirement picture.

Once you are comfortable that you are putting enough aside for retirement, spending your remaining income really comes down to priorities. In my family, my nephews have 12 aunts and uncles. Suffice it to say, they have plenty of toys and video games. But they **love** money. Children seem to recognize money's value at a very young age. So, instead of adding to their pile of toys, my wife and I usually try to give them money for college savings. We make the check out to the children and put it in a card. A nice mix of toys *and* money will give the instant gratification children want on their special days, as well as a practical, helpful gift they can enjoy years after they've forgotten about Sponge Bob.

Tax advantages

I've been talking about "tax-advantaged" savings plans throughout this article. Tax-advantaged refers to savings plans that provide tax breaks to encourage certain types of savings. IRAs are examples of tax-advantaged plans designed to promote retirement savings. The Federal government has developed similar tax-advantaged plans to promote educational savings. Below, I discuss these plans, as well as several alternatives, in more detail.

To explain the benefit of a tax-advantaged account, let me first explain how taxes are normally assessed. As you know, when you earn income from work, it is taxed at your income tax rate. If you invest this money, all earnings are subject to income tax or to capital gains tax. So any money you earn, whether it comes from work or from investments, is taxed.

Tax-advantaged plans, however, work in one of two ways. Some allow for income to be saved before taxes are taken out. These plans, usually retirement plans such as 401k's, allow you to deposit and earn money on your investments tax-deferred. When you eventually withdraw the savings, it is taxed at your current income tax rate. Other programs, such as Roth IRAs and **educational savings plans** do not allow you to put money in your account before paying taxes. However, all earnings and qualified withdrawals can be taken tax-free. Whether tax breaks are given at the beginning of the investment or at the end, these programs are a gift you should not overlook.

To give an example of how tax-advantaged educational savings can benefit you, over a period of 18 years, every $20,000 invested in a tax-advantaged program will result in an EXTRA $14,000 versus a taxable account!! Now that's putting your money to work! The benefits are not nearly as great for shorter time periods. **This is why I strongly urge people to take advantage of these programs as early as possible.**

Savings vehicles

There are six major options for educational savings: 529 Savings Accounts; Coverdell Education Savings Accounts (formerly known as Education IRAs); gifting money to students; saving in a traditional savings account; retirement accounts; and US Savings Bonds. Certain life insurance products are sometimes also marketed as educational savings vehicles. Without going into too much detail, I am of the opinion that life insurance is best suited for insurance purposes and not always appropriate as an investment choice.

Of the six major options, gifting money to students and savings accounts are the least desirable. Savings accounts have NO tax advantages and so should be eliminated first. Giving money to a student (under the Uniform Gift to Minors Act [UGMA] or Uniform Transfer to Minors Act [UTMA]) has several drawbacks. First, you as the gifter are responsible for paying any gifting taxes. Second, that money is now in the child's name and at age 18, that child can choose to spend the money however he or she wants. Unfortunately that may not be on one of the items you intended it for. Third, because that money is in the child's name, it has an unfavorable financial aid treatment. Finally, while minors may have a lower income tax rate, the tax savings don't compete with the tax-advantaged plans available for education purposes.

Choosing the right savings vehicle

At this point, we are left with four tax-advantaged options: 529 accounts; Coverdell Education Savings Accounts (also known by their acronym CESAs); savings bonds; and certain IRAs.

While some IRAs currently allow for withdrawals for education, these plans weren't designed for this purpose. It concerns me that at some point that opportunity may be closed by tax legislation. If it is, the savings you had placed in the accounts for educational funding won't be eligible for withdrawal for education purposes. For that reason, I do not recommend retirement accounts as educational savings vehicles.

Of the three vehicles remaining I am going to focus on the 529's and CESA's. That is because while all three types of plans provide for bond holdings, 529's and CESA's also provide a much broader range of investment choices. Let's take a look at the advantages and disadvantages of 529s and CESAs, and then examine scenarios where each may be most advantageous.

529 Savings Plans

529 plans, named after the section of the Federal tax code that refers to them, are administered (set up and run) by the states. Every state now has a 529 plan available. Note that a person does NOT have to be a resident of a state to contribute to its plan. In fact, states are competing against each other for your money, which has led to better offerings and lower costs. It is worth noting that while the states administer the programs, another party, usually an established financial institution, is responsible for the investment options. For instance, California's ScholarShare program's investment options are administered by TIAA/CREF.

529 accounts are considered assets of the custodian (parent), with the student named as the beneficiary. This allows for greater eligibility for financial aid. In addition, the beneficiary designation can be revoked or moved to another member of the family at any time. Each contributor to a 529 account can contribute $11,000 per year to the account. The lifetime value of an account can usually exceed $200,000 (it's $280,000 in the California ScholarShare plan). Unlike most other types of savings vehicles, 529's have no limits on contributions by those with higher income levels. And, anyone may contribute to a child's 529 plan. Finally, 529s usually feature options designed to take the guesswork out of the investing process. These "age-based" investment plans re-allocate the holdings depending on the time the student has until they are expected to enter school. (More on the advantages of age-based programs under the "plan maintenance" section, below.)

The primary concern with 529 plans is that the law that allows for these savings plans is set to expire in 2010. So, by 2010 Congress will have to consider whether to extend the tax treatment of 529 programs. I believe that 529s will either be extended or grandfathered, or replaced by another program. There is simply too much money in these plans and too many people participating to end the program. Furthermore, tax credits and breaks are constantly changing, along with our country's tax laws, so any plan can be revoked or changed at any time. Often, tax savings programs are modified to close loopholes or to stop people from taking advantage of programs in a manner they were not designed for. So far, this has not been an issue with 529s. So, we continue to invest in 529s, knowing that we are making the best decision given the information and tools we currently have. *{Update: In 2005 Congress is looking at several bills that will make 529 accounts permanent and they are expected to adopt, in some form, one of these proposals}*

Coverdell Education Savings Accounts (CESA's)

CESAs have 2 drawbacks when compared to 529s, and one major advantage. The first drawback is that CESAs have income limits for contributors. Joint filers are ineligible to contribute during any year their Modified Adjusted Gross Income (MAGI) is above $220,000. The contribution limits are reduced along a sliding scale for those with a MAGI between $190,000-$220,000.

The second drawback is that CESAs have low contribution limits. Each contributor can only contribute $2,000 total per year to CESAs. Additionally, each beneficiary can only receive a total of $2,000 combined per year in the account.

Where CESA's trump 529s, and this can be very valuable, is in their flexibility for funding lower education. CESA's can be used to pay the tuition, fees, supplies, and equipment costs for elementary and secondary school. This includes computers and software for education.

Additionally, CESA's are not sponsored by the state or any other government agency. Therefore, CESA accounts can be opened virtually anywhere, with unlimited investing options. While that flexibility can be an advantage for some, in my experience most parents don't have the time or knowledge to consistently manage that money. For many, a 529, which are managed by the state, is a safer choice for college savings.

Creating a plan

In most cases, I encourage clients to participate in both CESAs and 529s. We use the CESA for elementary and secondary school funding. This is particularly advantageous for children attending private or parochial schools. But, because money can be used for related costs, even parents of children in public schools can benefit from the savings.

After CESA accounts are fully funded, I recommend that remaining contributions be invested in a 529 plan. Researching 529 plans can be a daunting task. A good reference for those interested is www.savingforcollege.com. This website compares plans from every state and contains a lot of valuable information. The plan that is currently of most interest to me is New York's Direct 529 Plan.

New York's plan is one of the largest in the country. The program's investment manager is Vanguard. For those not familiar with Vanguard, it is one of the largest and most respected mutual fund companies in the country. Vanguard is known for having very good fund options with very low expense ratios.

The program's administrator is Upromise, which focuses entirely on educational savings plans. The combined management fee and fund fees are at .58%, the lowest in the county. The New York plan has fifteen different investment options, including three age-based allocation options. You can change investment options one time per year, or anytime you change the account beneficiary. Finally, if your employer participates, you can have contributions deducted regularly from your paycheck, which I've found to be a great way to ensure participation. Monthly contributions can be as little as $15. The low fees on Vanguard funds and the overall plan structure make the New York Direct 529 a good plan.

In addition to managing college savings plans, Upromise (www.upromise.com) has a unique program that allows families to save for college by making purchases. For instance, Citibank, Exxon, America Online, and McDonald's are participants who will help you save by donating a percentage of the money you spend to your child's 529 plan. To participate, you need to establish an affiliated 529 plan and sign up for Upromise. Upromise claims over 4 million families are participating with savings up to 10%. That could really add up over time!

Plan maintenance

Plan maintenance is a major factor in successfully saving for a child's education. What may be appropriate today may not be appropriate in the future. Typically, when looking at investments one of the major factors is what we call time horizon. That is, how long will this investment be allowed to grow before the money needs to be withdrawn? Over long periods of time, equities (stocks) have generally outperformed fixed income assets (bonds). Therefore, it is usually more appropriate to have a larger stake in equities when the time horizon is long. When the time horizon shortens, it makes sense to begin moving assets to fixed income securities; to reduce the risk volatility can have on returns. (Of course, this is only one of many factors to consider when investing. Speak to a professional before making investment decisions.)

Most investors who I work with simply don't have the time or expertise to keep up on their investments. Believe me, it's a full time job. With that in mind, I strongly urge investors who will not be using a financial planner to seek out investment alternatives that are actively allocated. In the case of college savings, that means using a 529 with an age-based allocation. Age-based allocations take into consideration the child's age and how long the money will be invested. They automatically place more into equities at the start and move more to fixed income as the time horizon shortens. Age-based allocations are designed so that you do not have to monitor this aspect of your investment.

CESAs do not offer age-based allocations, so they should be reviewed regularly and modified as needed. Remember, the time horizon on a CESA will generally be shorter than on a 529, so make sure that investments reflect this.

Summary

Education planning is important for all children. Those who will go to college are targeted in advertisements for savings programs, but these same savings programs can be used for other postsecondary education. All children should have the opportunity, and the expectation, of continuing education in a field of interest. Unfortunately, costs will continue to rise, especially at the more affordable public institutions. As a result, educational savings plans are more important to use than ever. Parents, grandparents and other relatives can help a child save for school by opening a savings plan that has tax advantages. These plans allow for the accumulation of more money over time that non tax-advantaged plans.

Nobody should wait until they can “afford” to save to open a plan. By making automatic payroll deductions for as little as $15 a month, a parent can begin funding a child’s education. Requesting relatives donate to the plan instead of buying toys for the child is another good way of saving. Participating in Upromise, which allows parents to save with the items they buy everyday, can also painlessly add money to educational savings. Finally, saving in the correct plans can provide more favorable financial aid calculations.

Adding this all together could make a big difference in your child’s life. It may allow him or her to receive a higher education, and can lead a more satisfying and successful life.