CPA Practice Advisor

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We all know a college education is very expensive, and costs are continuing to escalate. According to College Board's Trends in College Pricing, the average full-time student at a four-year, non-profit private university will pay $32,410 a year in tuition and fees. Add in room and board, and the price balloons to nearly $45,000. Over four years, that's comes to about $180,000 – and that's if the student graduates on time.

Like planning for retirement, saving for a college education is very expensive, but most people have many years to plan for it. The smart way to go about it is to start early, save a little money each year and let the money grow. The government also provides tax incentives to help with college savings.

This article will discuss the merits of investing in three primary college savings plans; consider providing your clients and prospects with advice and passing along the following information to them.

529 Plans

States can establish 529 Plans, or Qualified Tuition Programs, that allow you to contribute money to an account to pay for a student's qualified education expenses at a postsecondary institution. Educational institutions can also establish programs that allow you to prepay a student's qualified education expenses.

The taxpayer does not get a federal tax deduction for contributions to 529 Plans (some states allow for a deduction), but the investment in the plan grows tax free. There are no annual contribution limits, but many plans limit contributions to $200,000. No tax is due on distributions from a 529 Plan if the money is applied toward qualified education expenses (in the same year), including tuition, fees,

Possible pitfalls: Qualifying education expenses need to be reduced by any tax-free assistance and amounts applied toward education deductions, credits and ESAs. Investment options into 529 Plans may be limited.

Coverdell Education Savings Accounts (ESAs)

If your modified adjusted gross income is less than $110,000 ($220,000 for married filing jointly), you may be able to set up an ESA to pay for qualified education expenses of a designated beneficiary. The account must be owned by the beneficiary or the parent. Total contributions for a given beneficiary cannot exceed $2,000 per year, and they must be made by the due date of the return. Qualified education expenses for ESAs also include elementary and secondary education expenses, in addition to postsecondary education expenses. The expenses include tuition, fees, books, supplies, equipment, and room and board.

Contributions to an ESA are not deductible, but investments grow tax free until the money is distributed. Contributions cannot be made once the beneficiary reaches age 18 and the distributions must be made by age 30. The distributions are tax free if used for qualified education expenses in the same year. If distributions exceed education expenses, a portion of the earnings is taxable and may be subject to an additional 10 percent tax.

Possible pitfalls: Since contributions to ESAs are limited, the ESA may not be sufficient to fund the child's college education. Education expenses applied to an ESA must be reduced by tax-free educational assistance, an education deduction or credit, and the nontaxable benefit from a 529 Plan.

IRA Plans

equipment, and room and board for attending any college, university, vocational school or other postsecondary educational institution.

Planning strategies: Under this option, parents do not need to transfer the money into a child's account; as a result, the parents maintain control of the funds. The children can make contributions to their own IRA and reduce the tax paid on earned income.

Possible pitfalls: The distributions need to be made in the same year the education expenses are incurred; otherwise, the 10 percent penalty will apply. If the taxpayer doesn't qualify for an education credit or deduction and uses this IRA option, the taxpayer is, in effect, using after tax money to pay for the expenses.

Carefully Plan

There are pros and cons of investing in each of the three primary college savings plans. As you provide planning advice to your clients, you'll need to weigh out the merits of each plan and determine which plan best suits their situation. There are many tax rules with a lot of details and exceptions. As you meet with your clients, please be sure to review all the rules and apply them to the facts and circumstances accordingly.

Fidelity has a new "2K" rule to provide assistance on whether you have saved enough for college. The formula is to multiply your child's age by $2,000. If you have at least that much saved, you're on track to cover half the average cost of a four-year, public university (around $20,000 per year).

Finally, another element of college saving is to determine where to invest the money once the type of plan is identified. If you need help in this area, please seek the advice of a financial planner. For more information, read IRS Publication 970: Tax Benefits for Education.