<u>Article – College Savings</u>

Tax Planning for new mom's and young families is like the 4 prongs of the fork you use to feed the child.

Prong #1 – is for fully funding your own 401K/IRA. This is highly overlooked. Fully funding your own retirement saves the family the most taxes as it reduces the current taxable earnings and current tax burden. It grows tax deferred, is <u>not</u> considered an asset for financial aid consideration, and a 401K can be borrowed against to pay for college later or as an IRA can be withdrawn to pay for qualified higher education <u>without</u> penalty even if younger than 59 ½, although taxed when you take it out.

Prong #2 – are Coverdell IRAs (formerly known as Education IRAs). They grow tax free if you spend them on Educational costs. Limited to only $2,000/year per child, they too are often overlooked as being too small to bother with. But the nice advantage of these, is that while they can be used for college, they can also be used for K-12 Education costs without penalty which no other vehicle can. This means, you can begin funding them when the child is born, let them grow tax free for 4-5 years, then use them to pay for full day private Kindergarten, or ½ day supplemental Kindergarten. Then start building this account again to pay for college, or any other K-12 Education cost such as private school, a summer college credit program for high school students, etc. Be careful, these are limited by income, so if your income is too high, <u>you</u> may not be eligible for this one, but other relatives may be, and you can fund it through them.

Prong #3 – is the most popular and most talked about 529 plans. These not only grow tax free as long as the funds are used to pay for college, they have annual contribution limits tied to the gift tax exclusions – $14,000/person/year. This means Mom & Dad can <u>each</u> put this maximum amount away per year for each of their children until the year the child turns 17. This also means grandparents can do so for each grandchild – a terrific Estate Planning tool. But the best advantage of 529's is not a tax advantage at all, but the ability to maintain control of the funds. Unlike most other types of savings, the child cannot get their hands on this money simply by turning age 18. The 529 still lists the parent/grandparent as owner with the child as beneficiary. If the child gets a full scholarship, doesn't go to college or for any other reason doesn't need the funds for college, you can simply change the beneficiary to another relative – a sibling, cousin, even the parent themselves who perhaps never finished college themselves or needs it for grad school.

That brings me to the 4th prong – regular savings and investment accounts in the child's own name and social security number. Many parents are very concerned about the issue of control. They say they don't know how responsible that young child will be when they grow up and turn 18 and they don't want a lot of money accumulated in that account by the time they turn 18. My answer to them is to spend it, yes spend it.

Think of all the many costly purchases you make for your child over those 18 years. From child care, to nursery school, juvenile furniture, summer camp, gymnastic classes, music lessons, SAT prep classes and more. Some people think once they put money in their child's name, they can't take it out until college; not true. You simply have a fiduciary responsibility to only spend it on the child.

You use the 529, Coverdell IRA, and even your 401K to save for college. You use regular savings accounts outside of these special, listed accounts to pre-fund all the high ticket costs of raising that child. Most people don't see their kids as the cute little tax shelters they really are. The 1st $1,050 of earnings (interest, dividends and capital gains) are tax-free. The next $1,050 is taxed at the child's own low bracket. Try not to allow the child's taxable earnings to exceed $2,100 because this will backfire on you. To prevent you from getting overzealous in sheltering income by putting it in the child's name, the government has imposed what's commonly referred to as a "kiddie tax". This means that income greater than $2,100/year will get taxed at Mom & Dad's highest tax bracket. This can easily be avoided or minimized by investing in long-term growth stocks rather than those paying out current year dividends and by using tax-free investments as you approach that $2,100 mark. Of course, it is naturally minimized by the constant spending from this account that it was intended for.

To see how this last prong saves you tax money, say you prefund the next two years Tuition, after school programs and/or summer camp at a cost of $35,000/year or a total of $70,000. Let's say you keep adding to this account for a while at the same time as you spend from it. It maintains this $70,000 balance for a few years until you get closer to college age when you'll want to deplete it completely (so it has no effect on financial aid). If the $70,000 earned even 3%/year, that would be taxable income of $2,100/year. Again, the first $1,050 is free and the next $1,050 assuming no other income in their SS#, would be taxed at a maximum of 10% = $105. Compare this with the same funds having remained in Mom and Dad's name, taxed at their tax rate of 33% or higher, would result in income of $2,100 x 33% = almost $695 or more vs. $105 or less, a savings of almost $600/year x doing so for 12 years (and then depleting it by age 18). That would be a total savings of about $7,200 more in your pocket instead of Uncle Sam's. State/City savings depending on where you live, will increase this savings and parents in higher than 33% brackets will save even more.

As in all investing and savings, diversifying is a good thing, so taking advantage of all 4 prongs of the fork will feed your family's tax savings best.

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