

Saving for College: Strategies for Success

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It's never too early to start investing for a child's college education. The sooner you start, the more time your money has to potentially benefit from the power of **compound growth**, which is growth on top of growth. If the money you invest grows, then your original investment *plus its new value* can grow again, which means your money may grow at a surprising pace.

If you want to keep up with rising college costs, you should try to invest for growth. Historically, stocks have offered the best chance for your money to grow over the long term. If college is 10 or more years away, consider investing primarily in stocks and/or stock mutual funds.¹ Then, gradually move those funds to more conservative holdings as your child nears college age.

Is it ever too late to start?

What if you've put off saving, and college is only a couple of years away for your child? Should you skip saving altogether and hope for financial aid or fall back on loans? Not necessarily—saving late is better than not saving at all. Remember, college costs don't arrive all at once; they trickle in over four years (at least). Even if you wait until the last minute, you still have an opportunity to invest for college. If you're in this situation, you'll want to consider investments with a shorter time horizon.

The first part of your strategy: choosing the right account for you

The government has created two accounts—**529 plans** and **Education Savings Accounts** (also known as Coverdells)—to help you save for your children's college education. These accounts provide many advantages over **custodial accounts**, **general brokerage accounts** and **savings accounts**.

- A **529 plan**² is a state-sponsored program that allows parents, relatives and friends to invest for a child's college education. Generally, you can choose from a selection of age-based or static investment portfolios that are professionally managed by the program's fund manager. The account belongs to you, not your child, and any potential earnings grow tax-deferred. What's more, you pay no federal taxes on earnings as long as you withdraw the money to pay for qualified educational expenses.

College vs. Retirement

Don't raid your retirement savings to fund your children's college education. You can find other ways to pay for college, such as loans, scholarships and financial aid. If you need money for retirement, on the other hand, you'll have a hard time convincing a bank to give you a retirement loan. For more, see [The Parent Trap: College vs. Retirement](#).

529 plans don't limit how much you can contribute per year. Instead, they have a lifetime contribution limit (often greater than \$200,000) per beneficiary that varies by state.

- An **Education Savings Account** is managed by you on behalf of your child. You can invest the money you contribute to an ESA in stocks, bonds, mutual funds—pretty much whatever you're comfortable with. When your child turns 18, you can choose to hand over the reins or continue managing the account yourself.

ESAs provide tax advantages similar to 529 plans: Your money grows tax-free and you pay no taxes on earnings if you withdraw the money to pay for qualified educational expenses. However, ESAs can be used for certain elementary or secondary school expenses as well as for college expenses. You can contribute a maximum of \$2,000 annually, if you qualify.

- A **custodial account** is an account managed by a parent or guardian on behalf of a child. The money belongs irrevocably to the child, so if you're managing a custodial account for your daughter, when she turns 18, 21 or 25 (depending on the state rules governing the account), she can use the money for anything she wants—a new car or a European vacation, for instance.

Custodial accounts offer minor tax advantages and have no restrictions on how the money can be spent, as long as it's for the benefit of the child. If you want to set aside money for expenses that aren't covered by an ESA or 529 plan—sorority dues or private voice lessons, for example—a custodial account may be just the thing.

- You can use a **brokerage account** to invest for college, but it offers no tax advantages. A 529 plan, an ESA or even a custodial account is probably a better choice. However, supplementing your tax-advantaged college investments with a taxable brokerage account sometimes makes sense—for example, if you want to save money for nonqualified college expenses and maintain control of the money.
- A **savings account** may be a place to put away a few dollars for a rainy day, but it's a poor choice for college savings. Savings accounts usually don't even keep up with inflation, much less rising college costs.

The second part of your strategy: when and how to invest your money

18 years before college

- Open the account of your choice and contribute money every month, perhaps by signing up for an automatic investment plan. Contribute extra money whenever possible.
- If appropriate given your risk tolerance, invest the money in stocks or mutual funds for long-term growth.

8 to 10 years before college

- Has anything changed in your life? A new baby? A better-paying job? Consider these changes and recalculate your needs.
- If you haven't yet opened an account, do so right away. You may want to go with a 529 plan, which allows much larger lump sum contributions and may give you a chance to make up for lost time.
- Contribute any windfall money to your college savings account.

1 to 2 years before college

- Figure out your expected family contribution, a number that financial aid officers use to help evaluate your child's eligibility for financial aid.
- Look into your options for financial aid and scholarships.
- Reassess the risk level in your accounts. As college approaches, consider moving the money into less risky investments, such as shorter-term bonds and money market funds.

Comparing 529 Plans, Coverdell ESAs and Custodial Accounts

	529 college savings plan	Education Savings Account	Custodial account
Description	A state-sponsored, tax-deferred college investment program	An education savings account set up and managed by a parent or guardian for the benefit of a minor	A brokerage account managed by a custodian. Money can be used for college or any other purpose
Earnings	Tax-deferred	Tax-deferred	<p>Child under 19*</p> <ul style="list-style-type: none"> • First \$900 tax-free • Next \$900 taxed at child's rate • Any amount over \$1,800 taxed at adult's rate <p>Child 19 and over*</p> <ul style="list-style-type: none"> • First \$900 tax-free • Any amount over \$900 taxed at child's rate
Amount that can be contributed without the donor owing gift taxes	Up to \$60,000 (\$120,000 per couple) per beneficiary in a single year if contributor elects to recognize that gift over five years for tax purposes and makes no additional gifts to that beneficiary over the next five years	N/A	Up to \$12,000 (\$24,000 per couple) per beneficiary in a single year
Withdrawals	Federal-tax-free when used for qualified education expenses	Federal-tax-free when used for qualified education expenses	No special tax advantage
Contribution limits	Lifetime limit per beneficiary that ranges by state, generally upward of \$200,000 per beneficiary	\$2,000 per year, subject to adjusted gross income limitations (phase-out: \$190,000– \$220,000, married filing jointly; \$95,000– \$110,000, single)	No limit
Penalty for nonqualified use	Earnings taxed as ordinary income and may be subject to a 10% federal penalty	Earnings taxed as ordinary income and may be subject to a 10% federal penalty	N/A
Investment choices	Choice of investment portfolios that are managed by state's plan administrator	Managed by parent or guardian	Managed by custodian until account is turned over to beneficiary at age 18, 21 or 25, depending on state
Impact on financial aid	May minimally impact financial aid. Guidance from the Department of Education says that 529 plans are counted as assets of the parent or account owner in determining	May minimally impact financial aid. Guidance from the Department of Education says that ESAs are counted as assets of the parent or account owner in determining financial aid	May significantly impact financial aid

	financial aid		
Age limits	No age limit on beneficiaries	Beneficiary must be under 18. All assets must be distributed by child's 30th birthday	Beneficiary must be under 18

*Beginning in 2008, the so-called Kiddie Tax is extended to children under 19. In addition, full-time college students under the age of 24 will also be taxed at their parents' rate on unearned income in excess of \$1,800, unless the students' earned income is greater than one-half of their support.

Important Disclosures

Investors should consider carefully information contained in the prospectus, including investment objectives, risks, charges and expenses. You can request a prospectus by calling Schwab at 800-435-4000. Please read the prospectus carefully before investing.

1. While growth investments (equities and equity mutual funds) offer the potential to keep up with rising college costs, they put your principal at greater risk than income securities and bank products.

2. As with any investment, it is possible to lose money by investing in the Schwab 529 Plan. Before investing, carefully consider the plan's investment objectives, risks, charges and expenses. This information and more about the plans can be found in the Schwab 529 Guide and Participation Agreement available from Charles Schwab & Co., Inc., and should be read carefully before investing. If you are not a Kansas taxpayer, consider before investing whether your or the beneficiary's home state offers a 529 Plan that provides its taxpayers with state tax and other benefits not available through this plan.

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