Cooperative Extension Service
College of Tropical Agriculture and Human Resources
University of Hawai‘i at Mānoa

Financial Connections
(revised) Jan. 2004
FC-46

Saving for Your Children’s College Education

Ron Wall, Extension Specialist in Family Economics and Management

Resolutions for a new year

Resolutions are a great way to begin a new year. They remind us of all the things we would like to achieve, and they focus our attention on those that are dearest to us. Perhaps you have children, and it is their success that drives you. You want them to be well fed, well clothed, well sheltered and, and above all, well educated. But education is costly—particularly college education—and you are concerned that you won’t be able to afford it when the time comes. Below are some ways that you can save for your children’s education.

Individual savings and investments

You could simply start your own portfolio of savings and investment funds. You could set money aside each week or each month in a savings account. When the saving became great enough you could then purchase higher-interest certificates of deposit or you could purchase shares in a mutual fund. For a child six or under, you might put as much as 90% in broad-based stock funds and the rest in CDs or short-term bonds. As the child grew older, you would gradually change these proportions, until by the age of 16 or 17 you would have only 10% or less invested in stocks and the rest invested in cash or bonds. Following this approach, you would pay the tax on earnings as they are earned. And as long as the money was held in your name, only a small portion of it would probably be counted against your child’s eligibility for financial aid.

Education IRA

Another approach to saving for college is to use an Education IRA. The Education IRA allows parents and certain relatives to place up to $2,000 per child per year into a nondeductible, tax-free account to be used for higher education. The funds can be placed in any investment open to IRAs, but upon withdrawal they must be used for eligible higher education expenses in order to be received tax-free. Money contributed must be derived from employment compensation, and the income of the contributors must not exceed $220,000 for joint filers or $110,000 for single filers. Phase-out starts at $190,000 and $95,000, respectively.

Roth IRA

Roth IRAs allow parents to put up to $3,000 per year each into a nondeductible, potentially tax-free IRA. Contributions can be withdrawn tax-free and penalty-free at any time for any reason. But earnings can only be withdrawn tax-free after five years from the start of the account and after the holder has reached age 59½. However, earnings can be withdrawn penalty-free but not tax-free prior to age 59½ if used to pay college expenses. The Roth IRA allows parents to build earnings for their retirement while they set aside up to $6,000 per year in contributions for their children’s college education. Income eligibility for the Roth IRA is like that for the Education IRA. Be forewarned, however, that parents who are using the Roth IRA as a critical component of their retirement savings plan should be wary of withdrawing funds for any other purpose.

State-sponsored 529 plans

What are called 529 plans were established by federal legislation to allow parents to prepay a student’s higher education tuition and fees or put money aside in a tax-free college savings plan to pay a student’s qualified higher education expenses. Each state decides the details of the plans it will offer within the federal guidelines. All 50 states and the District of Columbia have 529 plans, but Hawaii offers only the tax-free savings plan. This plan is marketed and managed by a private investment firm in Hawaii, but Hawaii residents can choose plans from other states and other investment firms outside the state. Anyone can contribute to a 529 plan for any beneficiary, and each individual can contribute up to $55,000 in one year for each beneficiary as long as no further contributions are made during the next five years and the total accumulation does not exceed a specified limit. The money is placed in a selection of investment funds chosen for the plan. These are usually moderately aggressive funds with the mix becoming more conservative as the beneficiary gets closer to starting college. If the funds cannot be or are not used by the designated beneficiary, another beneficiary can be assigned. For further information about these types of plans go to www.collegesavings.org.

Published by the College of Tropical Agriculture and Human Resources (CTAHR) and issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Andrew G. Hashimoto, Director/Dean, Cooperative Extension Service/CTAHR, University of Hawaii at Manoa, Honolulu, Hawaii 96822. An Equal Opportunity / Affirmative Action Institution providing programs and services to the people of Hawaii without regard to race, sex, age, religion, color, national origin, ancestry, disability, marital status, arrest and court record, sexual orientation, or veteran status. CTAHR publications can be found on the Web site <http://www2.ctahr.hawaii.edu> or ordered by calling 808-956-7046 or sending e-mail to ctahrpub@hawaii.edu.