Start Early to Build Savings for College

Just thinking about sending your youngsters through college is likely to put you in a school daze. According to the latest figures from the College Board, the average total charges (tuition, fees, room and board) at four-year private colleges and universities in 2005-06 are $29,026.

College costs have been increasing by 5.7 percent a year over the past decade. If this pace keeps up, costs will double in about 13 years. Thus, if your five-year-old is fortunate enough to get accepted to Princeton or Stanford, you'll be "fortunate" enough to pay around $80,000 a year, or $320,000 for a degree.

Moreover, that's the average. Many private universities—including those generally thought to be "elite"—charge around $40,000 for a year on campus. And that's before airline tickets, pizza and cell-phone bills.

Such costs have been increasing by 5.7 percent a year over the past decade. If this pace keeps up, costs will double in about 13 years. Thus, if your five-year-old is fortunate enough to get accepted to Princeton or Stanford, you'll be "fortunate" enough to pay around $80,000 a year, or $320,000 for a degree. Sending three youngsters to the Ivy League could run into seven figures.

It's true that some colleges, especially publicly funded state schools, have costs that are lower than average. And it's also true that your youngsters may grow up to be place-kickers or concert pianists and to earn full or partial scholarships. Those happy circumstances would reduce your education outlay.

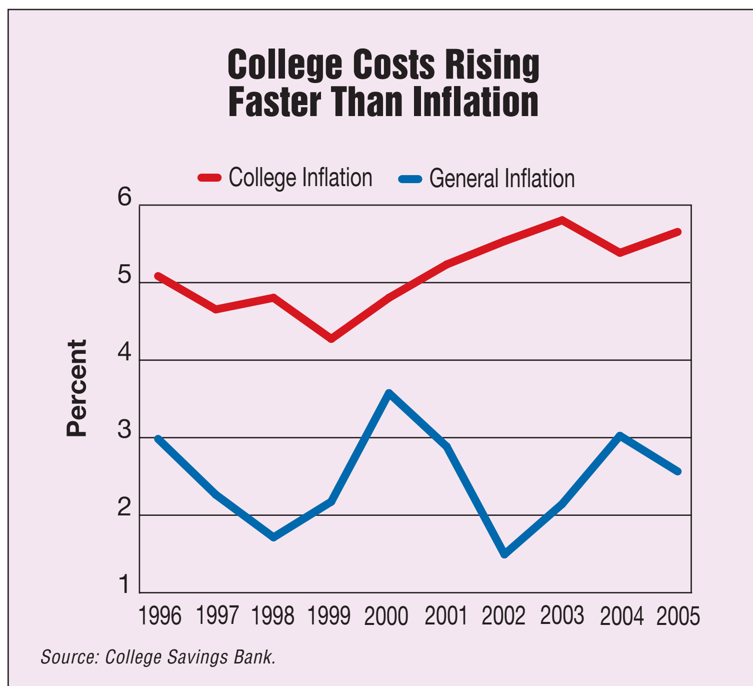
On the other hand, physicians' children are not likely to qualify for needs-based financial aid unless they have several siblings in college at the same time. Moreover, you very well may wish to send your kids to graduate school (perhaps even

medical school), which could double the cost of a four-year degree. The bottom line, then, is that sending your children through college probably will be a major expense, one that needs to be anticipated.

The sooner you start such planning, the better. "I advise parents to start putting money into college funds as soon as possible," says Diahann Lassus of Lassus Wherley & Associates, a wealth-management firm in New Providence, N.J., "even if it's only a small amount per month. The power of compounding can be extraordinary over 17 or 18 years, and the more that you build up now, the less of a cash drain you'll face in the future, when your children go to college."

There are a number of options available for accumulating and investing college funds. Some offer tax breaks to parents and grandparents who put away money for this purpose.

Many financial advisers are enthusiastic about so-called Section 529 plans, named after a portion of the tax code. These



Source: College Savings Bank.

plans, also known as qualified tuition plans, are offered by most states and by some financial firms. There are no income limits on contributors, and some plans allow you to contribute many thousands of dollars per student.

Any investment earnings are tax-free, inside 529 accounts; under current law, withdrawals are tax-free if used to fund higher education. Among 529 plans, there are two major categories:

Many financial advisers are enthusiastic about so-called Section 529 plans, named after a portion of the tax code. These plans, also known as qualified tuition plans, are offered by most states and by some financial firms. There are no income limits on contributors, and some plans allow you to contribute many thousands of dollars per student.

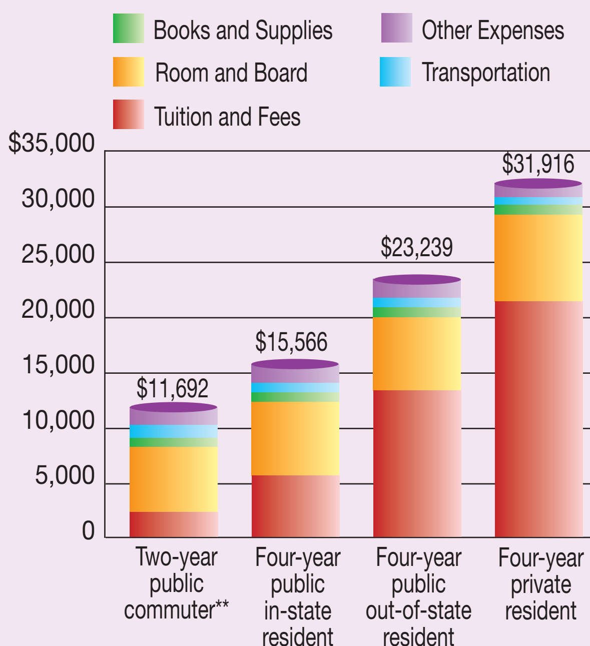
- **College savings plans.** In these plans, which really are investment plans, your account will grow (or shrink) depending on how specified investments perform. Say you invest $10,000 in State A's 529 savings plan, selecting a certain mix of investments. If those investments grow by 10 percent, your account would be worth $11,000. If those investments decline by 10 percent, though, your account balance would drop to $9,000.
- **Prepaid tuition plans.** Offered by some states, these plans guarantee a return that will match in-state tuition increases. Say you invest $10,000 in State B's 529 prepaid tuition plan, and college tuition in State B increases by 6 percent. Now your account is worth $10,600, regardless of what happens in the stock or bond markets.

From the above description, prepaid tuition plans seem like a good deal, especially with college costs escalating rapidly. However, they may have been too good a deal; many states have halted enrollment or increased the prices they are charging. "Several states have decided to cut their losses with the prepaid plans by closing them to new enrollments," says Joe Hurley, founder and CEO of Savingforcollege.com. "The ones that remain open to enrollment are counting on decent stock market returns, tuition inflation moderation and higher pricing (charging premiums) on their tuition contracts."

As the name suggests, money accumulated in 529 prepaid tuition plans can be spent only on tuition (and perhaps manda-

tory fees). You also lack educational choices if you use a prepaid tuition plan: with most of these plans, money can be spent only at the sponsoring state's public universities. In a few states, money can be spent at private universities—but still within the sponsoring state. If your child decides to go to a college that's

Sample Average Undergraduate Budgets, 2005-06 (Enrollment Weighted*)



* Enrollment-weighted tuition and fees are derived by weighting the price charged by each institution by the number of full-time students enrolled. Room and board charges are weighted by the number of students residing on campus.

** Average total expenses include room and board costs for commuter students, which are average estimated living expenses for students living off campus but not with parents.

Source: Trends in College Pricing, 2005, The College Board.

not covered, you usually can get your money back with a scant return on your investment or no return at all.

Some of the problems with prepaid tuition plans are addressed by a new entry, the Independent 529 Plan (*www.independent529plan.org*). "The Independent 529 Plan seems to make more sense," says Mr. Hurley, "as long as you understand that it only works well for the family sending the child to one of the participating institutions." With this plan, your tuition guarantee can be used only at specific colleges that have reached agreements with the Independent 529 Plan. The roster includes over 250 private universities, from Amherst to Washington University in St. Louis.

One strategy, then, is combining 529 plans. You might put enough money into a prepaid tuition plan (a state plan or the Independent 529 plan) to lock in full payment for some future tuition. "Even with the premiums they're charging," says Mr. Hurley, "prepaid plans may still make sense for younger children. The states offering such plans will in all likelihood make good on their promises."

In addition, you can contribute to a 529 savings plan for your youngster. Under current law, tax-free withdrawals from a 529 savings plan can be used not only for tuition but also for room and board, books, etc. Within these plans, your money will be managed by investment professionals, and your ultimate payoff will depend on the performance of the investment accounts.

Which 529 Plan to Choose?

For prepaid tuition or 529 plans, many investors favor their own state's 529 plans because of state tax deductions. State tax features should be considered, but you shouldn't automatically choose your own state's plan. Find out how much you'll actually save in taxes, and see if those savings are worth what you might give up in other features.

Generally, state tax breaks come in two forms. Your initial deductions may be tax deductible, and ultimate withdrawals may be exempt from state income taxes, if used for higher education. (A few states also provide matching contributions.) In order to evaluate these breaks, you need to know how much they're worth:

■ **Tax-free income.** If you live in a state with no state income tax, such as Florida, this consideration isn't meaningful. Moreover, most states will not tax 529 distributions from other states' plans if the money is used for higher education. A few states exempt their own plans from income taxes, yet tax 529 withdrawals from other states.

As a result, this provision shouldn't influence your choice unless you live in one of those states. Check out your own state's law: if the state income tax is high, and you'll owe state tax on withdrawals from out-of-state plans, you should consider staying with your own state's plan.

■ **State tax deductions.** About half of the states allow you to take state income tax deductions for 529 contributions. Thus, if you put $100,000 into a 529 plan for your child, you'd deduct $100,000 from your taxable state income. Again, such a benefit won't be offered in states with no income taxes, so those residents should scan all states' 529 offerings.

If your state offers a deduction, you need to look at the fine print. There may be a cap on the amount you may deduct. New York, for example, limits this deduction to $5,000 a year, or $10,000 on a joint return. You and your spouse, therefore, would have to spread contributions over 10 years in order to get a $100,000 deduction. In some states, limits may be much lower, with excess amounts carried forward to future years.

The next step is to place a value on this deduction. If you live in a state (or city) where the income-tax rate reaches 10 percent, a $10,000 tax deduction could save $1,000 per year in a family's taxes. Counting Federal taxes, the value of this tax break would be less; taxpayers subject to the alternative minimum tax, though, get no Federal deduction, so the state tax savings will be welcome.

■ **Matching contributions.** A few states sweeten the pot by adding dollars to your account. A 529 account owner in Louisiana with a six-figure income would get a 2-percent match, for example—contribute $10,000 and see your account balance start at $10,200.

Once you know the value of in-state tax breaks, you can weigh tradeoffs. What are you giving up by limiting your choice of 529 plans to your home state's entry, and will the sacrifice be worth

the savings in taxes?

Beyond the tax considerations, 529 plans may vary in other ways. One critical variable is the cost of the plan. Some 529 plans are run by firms such as Vanguard and TIAA-CREF, which have reputations for low management fees. Other 529 plans have higher costs; some states pay financial advisers to place clients in those plans, and the advisers' fees may add to the plans' expenses.

Investment choice may be the key issue, though. Some states allow participants to invest only in fixed-income instruments. That may be fine with you, if you want to be very conservative with your college funds. Indeed, during the last bear market, that was a winning strategy. Historically, though, fixed-income returns have lagged behind those from the stock market.

If you prefer to put your college money into equities, there are many 529 investment plans from which to choose. Some are age-based, meaning that your child's asset allocation automatically becomes more conservative as he or she nears college. Other 529 plans allow you to self-direct your investments; some even provide several investment managers to handle your contributions.

If you'd rather not put your college money into a prepaid tuition plan or into all fixed-income, there are many 529 investment plans from which to choose. Some are age-based, meaning that your child's asset allocation automatically becomes more conservative as he or she nears college. Other 529 plans allow you to self-direct your investments. Some even provide several investment managers to handle your contributions.

The bottom line? You should see how your home state's 529 plans stack up with other states' plans, in terms of investment options. "If we're neutral on investment choices, we prefer in-state plans," says Alan Gotthardt, president of Brightworth, a private wealth management firm based in Norcross, Ga. Superior investment choices, however, may outweigh the benefits of state tax breaks.

As Mr. Gotthardt points out, "State rules on 529 plans seem to change every day." Fortunately, current law permits you to roll over 529 assets to a different state's plan, tax-free. Once you make your initial 529 selection, you should keep up with any

revisions and decide whether it makes sense to move your money across state lines.

Other benefits may be offered by 529 plans. If the money is not needed for college because of death, disability or a scholarship award, penalty-free withdrawals are permitted. You also can roll over the account balance from one student to another family member's account, tax and penalty free.

In addition, money contributed to 529 plans is exempt from estate tax; yet that money may be recovered, if needed, subject to a 10-percent penalty. "You can give up to $60,000 to 529 plans and elect to have that gift spread over five years, for gift tax purposes," says Mr. Hurley. "Such gifts may therefore qualify for the $12,000 annual gift tax exclusion so you can remove assets from your taxable estate without incurring a gift tax." For married couples, up to $120,000 can be put into a 529 plan and spread over the five-year period.

Besides the tax advantages, Section 529 plans provide parents with control of the money that's meant to be used for college. There is no risk your child will use the cash to buy a sports car or take an extended vacation. On the other hand, with a traditional custodial account, the money will belong to the child when

Look Into These Tax Credits

Tax breaks for higher education don't stop with 529 plans and Coverdell Education Savings Accounts. "For most Americans, the Hope Credit and Lifetime Learning Credit are tax-savvy ways to save extra dollars that would otherwise go to the IRS," says David John Marotta, president of Marotta Asset Management in Charlottesville, Va.

- The Hope Credit saves you up to $1,500 per year for the first two years of enrollment at a post-secondary school. You will receive a tax credit, dollar-for-dollar, on the first $1,000 spent on qualified higher education and 50 cents on the dollar for the next $1,000. You may take the Hope Scholarship credit for each college freshman or sophomore in your family.
- The Lifetime Learning Credit provides a tax credit of 20 percent for up to $10,000 spent on tuition, fees and books. "Although the Lifetime Credit can be taken for an unlimited number of years," says Mr. Marotta, "you may not deduct more than $2,000 per tax return. Even

he or she comes of age, at 18 in many states. For a rundown on various states' 529 plans, log on to *www.savingforcollege.com*.

Considering Coverdells

Beyond 529 savings and prepaid tuition plans, you also may decide to put money into Coverdell Education Savings Accounts (ESAs). Such accounts permit you to contribute up to $2,000 per beneficiary per year and to take tax-free withdrawals for a wide variety of education expenses. Individuals can make contributions for one year up to April 15 of the following year.

Coverdell ESAs offer advantages over 529 plans. They act like individual retirement accounts, so you can control how the money will be invested. "In addition, tax-free payouts will be allowed for elementary and secondary school expenses, including those to attend private and religious K-12 schools," says Marty Abo, a CPA in Voorhees, N.J. "Qualifying expenses include not only tuition but also uniforms, transportation and even the cost of computers and related equipment, including most software and the cost of providing Internet access."

Typically, money can't be contributed to a Coverdell ESA after age 18, but that deadline is extended for special-needs ben-

if you have two or more members of your family in college, you will not be able to deduct more than $2,000 per year."

The catch? Both of these tax-credit benefits are phased out for earnings between $42,000-$52,000 ($85,000 and $105,000 for couples filing jointly). Education tax credits can be taken for you, your spouse or any dependent enrolled in school. However, you may not take both tax credits for the same person.

Although these income limits may disqualify some physicians' families, that's not always true. "In some cases," says Mr. Marotta, "parents who do not qualify for the education credits may forgo claiming an eligible dependent. The student may then claim the education credits on his or her own return."

If you do not qualify for the Hope or Lifetime Learning credits, you may still be eligible for a tuition-and-fees deduction of up to $4,000. This benefit is phased out for those earning between $65,000 and $80,000 ($130,000 and $160,000 for couples filing jointly).

eficiaries, who also can retain money in an ESA after age 30, the deadline for most students. This extra latitude is intended for students with physical, mental or emotional disabilities.

The only drawback: there are income limits to ESAs. Married couples with adjusted gross income (AGI) over $220,000 are excluded while those with AGI in the $190,000-$220,000 range can contribute less than the $2,000 maximum. If you file as a single taxpayer, your AGI must be under $95,000 to contribute the maximum while those over $110,000 in AGI are shut out.

Beyond 529 plans, you also may decide to put money into Coverdell Education Savings Accounts. Such accounts permit you to contribute up to $2,000 per beneficiary per year and take tax-free withdrawals for a wide variety of education expenses. Individuals can make contributions for one year up to April 15 of the following year.

In practice, this may make no difference because any number of people can contribute to your child's ESA. "If you and your spouse are over the limit, each of four grandparents can put in $500 per year, assuming their AGIs are under $190,000," says Tom Ochsenschlager, vice president of taxation for the American Institute of Certified Public Accountants, based in Washington, D.C. In addition, it may even be possible for your professional corporation to make the contribution.

Transfer Assets Wisely

Chances are, you'll have to tap some of your own assets to pay college bills. "If you plan on selling stock to pay for college expenses, reduce Uncle Sam's cut on earnings by gifting the stock to your child," says David John Marotta, president of Marotta Asset Management in Charlottesville, Va. Selling appreciated stock will cost you 15 percent in capital gains. Instead, your children will be in a lower tax bracket so they can sell the stock at a 5-percent tax rate.

According to Mr. Marotta, only parents who do not qualify for financial aid should pursue this option. "If you qualify for financial aid," he says, "moving assets into your child's name may be a bad idea because the student's assets are assessed at a higher rate." Tax savings gained by gifting appreciated stock will not

make up for your loss in financial-aid eligibility. As mentioned, though, physician's children are not likely to qualify for a great deal of needs-based aid, so this can be a savvy move.

Similarly, setting up custodial accounts for young children will reduce the amount of financial aid for which they'll qualify. However, because your youngsters may not be eligible for needs-based aid anyway, you may as well save some tax dollars by shifting investment income into their names.

Setting up custodial accounts for young children under the Uniform Transfer to Minors Act or the Uniform Gift to Minors Act will reduce the amount of financial aid for which they'll qualify. However, because your youngsters may not be eligible for needs-based aid anyway, you may as well save some tax dollars by shifting investment income into their names.

"Custodial accounts may be set up under the Uniform Transfer to Minors Act (UTMA) or the Uniform Gift to Minors Act (UGMA)," says Femi Shote, managing director of Asset Harvest Group, a financial planning and investment advisory firm in McLean, Va. "Either type will enable minors to own bank accounts, stocks, mutual funds and so on."

Custodial accounts are simple and inexpensive to create and maintain. In addition, transferring income-producing assets to a child's custodial account can save taxes, year after year.

Suppose, for example, you are in the top 35-percent tax bracket. You have $40,000 in a bond fund yielding 4.25 percent. Thus, this fund generates $1,700 worth of taxable income each year, and a $595 Federal income tax bill, at 35 percent.

If you transfer equal shares of the bond fund to two custodial accounts, one for each of two children, the income tax bill will be transferred as well. Your children likely will owe a total of $85 in tax, assuming they have no other investment income. Thus, shifting assets can save your family $510 in Federal income tax in one year. (This example works for young children. After youngsters reach age 14, they will be entitled to larger amounts of income at favorable tax rates.)

Under current tax law, in 2008 the 5-percent tax rate on stock dividends and long-term capital gains will be zero percent. Therefore, you should start planning to have your 14-and-up

children take capital gains in 2008, up to the limits of the 15-percent tax bracket for single taxpayers that year.

Before you transfer all of your investments to your children, though, you should know how the “kiddie tax” works. “In 2006, children under age 14 can have as much as $1,700 in favorably taxed unearned income,” says Roger Lusby, tax partner in the accounting firm Frazier & Deeter in Atlanta.

The kiddie-tax rules cover “unearned income” from investments, rather than earned income from wages, babysitting, etc. In 2006, each child under age 14 may have $850 worth of investment income that’s untaxed.

The next $850 is taxed at the child’s rate, which usually is 10 percent, the lowest Federal income tax rate. However, dividends from stocks and stock funds and long-term capital gains are taxed at only 5 percent this year for most children under 14. Thus, in situations where a young child has dividends or long-term gains, the tax rate on the next $850 in income will be between 5 percent and 10 percent, depending on how the income is allocated.

“Over the kiddie-tax limits,” says Mr. Lusby, “additional unearned income is taxed at the parent’s rate. Therefore, you should try to keep investment income for young children under the $1,700 level in 2006.”

After your children reach age 14, the kiddie tax no longer applies. From that age on, each child gets his or her own tax rate. In 2006, for example, single taxpayers can have up to $30,650 in taxable income, taxed no higher than 15 percent. As a result, you can shift much more investment income to your children after they reach age 14.

Although using custodial accounts may save taxes, there are negatives, too, such as the following:

- **Financial aid.** As mentioned, transferring assets to custodial accounts will reduce your family’s chances for financial aid.
- **Lack of control.** Custodianship ceases when a child attains the age of majority, which is between 18 and 21, depending upon state law. At that point, the youngster automatically acquires control over any assets in these accounts. In a worst-case scenario, money intended for college may be donated to a “guru” or used to buy an expensive car.

This potential problem creates another reason to avoid making very large transfers to very young children. As your kids mature, and they seem to be responsible, you can transfer more assets to their custodial accounts for greater tax savings.

■ **Support issues.** In some states' laws, custodians may face tax problems if they use a custodial account for money they're obligated to spend as a parent.

Last-Minute Maneuvering

An early start is key to making the best use of a 529 plan. If you begin when a child is a newborn and invest, say, $5,000 a year in a college fund, by the time he or she is 18, that $90,000 may have grown to hundreds of thousands of dollars, if you've invested in a carefully diversified portfolio.

But what if your child already is in college, or about to graduate from high school? Is it too late to use a 529 plan?

Not necessarily, according to Joe Hurley, founder and CEO of Savingforcollege.com. "Rather than pay the upcoming tuition bill directly from your other savings, first put the money into your state's 529 plan so that you can claim a state income tax deduction," he advises. "Then use the 529 money to pay the college bills."

The result: part of the cost of college becomes a deduction on your state income-tax return. You may save hundreds of dollars in state income taxes (or more, in some cases) simply by putting the money through the 529 plan.

This strategy works if you live in one of the states offering a tax deduction for 529 contributions, and it works best in states that do not require that the funds be held in the 529 plan for any minimum period of time. "Very few states require this," Mr. Hurley points out.

The following states allow their taxpayers to claim some or all of their contributions to the in-state 529 plan as a deduction or credit in computing state income taxes: Arkansas, Colorado, District of Columbia, Georgia, Idaho, Illinois, Iowa, Kansas, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Vermont, Virginia, West Virginia and Wisconsin.

"The rules governing state tax treatment of 529 plans are notoriously fickle," warns Mr. Hurley. "Before acting on this idea, please consult with your own tax professional."

Suppose, for example, you tap your daughter's bank account to pay for her wardrobe and electronic gear. The IRS may say that the custodial account really was used for your benefit, not for your daughter's, so the taxable income generated by that account should be reported on your tax return.

Practically speaking, this may not be an issue for some people. For physicians with substantial incomes, though, picking up the tab for children's clothing, iPods, etc., may be considered a normal support obligation. If so, the custodial account you tap could be taxed as if it were yours. You should check with a professional adviser about your state's rules before using funds in a custodial account for expenses that might be deemed your parental responsibility.

Many parents, then, will do some (but not necessarily all) of their college saving in custodial accounts. Other funds might go into Coverdell ESAs and 529 plans.

"Some of the tax breaks now offered by 529 plans are due to expire after 2010," says Mr. Shote. Therefore, this tax shelter may not last beyond 2010 in its present form. For now, you might put some money into 529 plans, but you may not want to rely on them for all of your college funding because of the uncertainty over future taxation.

In addition to 529 plans, you might put some of your college money into "tax-managed" mutual funds, offered by major fund companies. "These funds hold stocks, so investors have the potential for stock market gains," says Mr. Shote. "The fund managers handle trading so that investors don't have to pay taxes each year, as long as they hold onto their shares in the fund."

If you invest college money in a tax-managed fund, you can keep the account in your own name. The money won't be turned over to your youngster when he or she comes of age. Instead, you remain in control.

When your children are ready to go to college, you can sell shares of this fund to

We love hearing your comments and suggestions! Please fill out our short Reader Survey by clicking on the Reader Survey line at the bottom of the home page at *www.doctorsdigest.net*.

raise money. If the shares have gone up in price and tax will be owed, you can first give your shares to the student, as described above. Your child, who probably will be in a low tax bracket, can sell the shares, pay tax at a low rate and use the net sales proceeds to pay for higher education.

Options for Borrowing

In most cases, parents who have not saved in advance for college (and many who have saved some, but not enough) will have to borrow to pay for higher education. In those circumstances, several options may be available:

- **Home equity loans.** Borrowing against a home equity line of credit is a popular way to help pay college bills. Because these loans are secured by your home, the interest likely will be deductible. Interest on home-equity debt is deductible for the portion of the loan up to the value of your home or $100,000, whichever is less.

As of this writing, the average interest rate on a home equity line of credit was around 6.5 percent, so these loans offer low rates as well as tax breaks. You must be prepared to repay these loans, though, to avoid losing your home.

- **PLUS loans.** Federally guaranteed college loans are available through the Parent Loans for Undergraduate Students (PLUS) program. These loans are made to parents, who are responsible for paying them off, not to students.

As of press time, it was widely anticipated that the Federal government would soon pass a law changing the PLUS rules. For loans disbursed on or after July 1, 2006, these loans will switch

Tax Rules Explained

See IRS Publication 970, Tax Benefits for Education, for more information on tax benefits for educational costs. This publication is available through the Internal Revenue Service Website (*www.irs.gov*) or by calling the IRS at 1-800-829-3676.

This publication explains tax benefits that may be available to you if you are saving for or paying education costs for yourself or a member of your immediate family. Most benefits apply only to higher education.

to fixed rate from variable rate. The fixed rate initially will be 8.5 percent; unlike fixed-rate home loans, PLUS loans cannot be refinanced at a lower rate if interest rates drop.

On the plus side, these loans will now be available to parents of graduate and professional students, effective July 1, 2006. This will vastly increase these students' access to Federally insured loans, because the limit on PLUS loans is the total cost of attendance (including travel and books) less other financial aid received.

Whether you or your child borrows via a PLUS, Stafford or Perkins loan, taxation of the interest payments will be similar. A deduction is allowed for up to $2,500 worth of interest paid each year, for up to five years. Thus, taxpayers who are repaying these loans can deduct as much as $12,500 over a five-year period.

PLUS loans are either provided by private lenders or by the government. Repayment begins 60 days after the funds are fully disbursed, and the repayment term is up to 10 years. As mentioned, PLUS loans are the financial responsibility of the parents, not the student.

■ **Stafford Loans.** These loans go to students, without requiring credit checks or collateral. Again, a new law is expected to make these loans fixed, rather than variable, as of July 1, 2006. The new rate (which cannot be refinanced) will be 6.8 percent.

The new law also will increase Stafford loan limits for first- and second-year college students. Starting July 1, 2007, the limit for freshmen will rise to $3,500 from $2,625. Sophomores can then borrow $4,500, compared with $3,500 today. The limit for juniors and seniors, $5,500 per year, will not change.

In addition, there will be a phase-out of Stafford origination fees. The government now charges an origination fee equal to 3 percent on Stafford loans. (Some lenders pay this on behalf of borrowers.) Under the new law, the origination fee on Stafford loans will fall to 2 percent on July 1, 2006, then drop by one-half of a percentage point per year until reaching zero in 2010.

Again, Stafford loans can come either from a private lender or direct from the Federal government. To apply for a Stafford loan, students must submit the Free Application for Federal Student Aid (FAFSA). Even though unsubsidized Stafford loans are

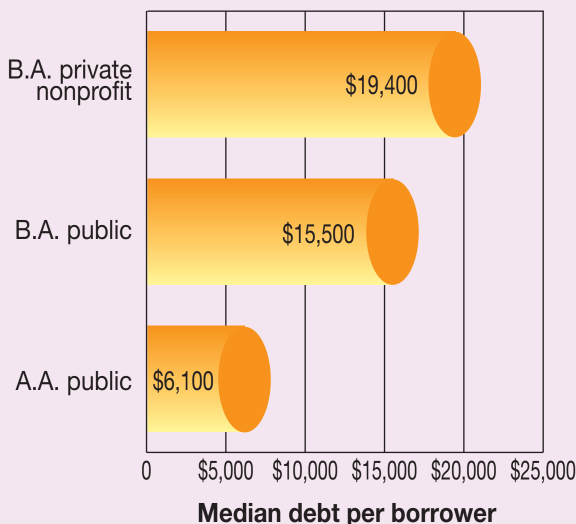
available to all students regardless of financial need, they must still submit the FAFSA to be eligible. (Subsidized Stafford loans are awarded on the basis of financial need.) Your youngster may receive a subsidized loan and an unsubsidized loan for the same period.

Students may apply on-line for these loans; for information go to *www.staffordloan.com*. There are several repayment options; the standard is to begin six months after leaving school.

- **Perkins loans.** These are low-interest loans to needy students. The interest (at a 5-percent rate) is paid by the Federal government during the in-school and nine-month grace periods. There are no origination or guarantee fees, and there is a 10-year

Student Debt Levels, 2003-04

(By degree and institution type)



Note: Debt levels include Federal and non-Federal student loans. Parent loans and credit-card debt are not included.

Source: Trends in Student Aid 2005, The College Board.

repayment period. However, the children of physicians may have a difficult time qualifying for this program.

Whether you or your child borrows via a PLUS, Stafford or Perkins loan, taxation of the interest payments will be similar. A deduction is allowed for up to $2,500 worth of interest paid each year, for up to five years. Thus, taxpayers who are repaying these loans can deduct as much as $12,500 over a five-year period.

There are income limits for these deductions, though. Single borrowers whose incomes are under $40,000 can qualify for the full deduction. For single borrowers, the deduction will be gradually reduced for annual income levels of $40,000 to $55,000.

Married taxpayers who report incomes of $60,000 or less on a joint return also can take the full deduction. The deduction will be gradually reduced for couples reporting adjusted gross income of $60,000 to $75,000.

As an added bonus, borrowers do not have to itemize their deductions to claim the interest deduction; they can file a Form 1040A or Form 1040EZ tax return. However, a student cannot file for the student-loan interest deduction if he or she is claimed as a dependent on his or her parent's income-tax return.

Although these loan programs are available, you should try to avoid borrowing huge amounts to pay for your children's college costs. Repaying large amounts of education-related debt can put a crimp in your retirement plans.

To hold down this debt burden, consider sending a child to a public university or even a junior college rather than to an expensive private institution. Another tactic is to borrow money for college costs, yet structure the loans so that your children will be the ones responsible for some of the repayment. Your children may qualify for lower-cost loans and get more tax deductions for the interest repayments.

Perhaps most important, plan ahead to reduce your need for student loans. Start early, invest regularly, and use as many tax breaks as you can to build up a sizable college fund.