

# financial focus



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## PAYING FOR COLLEGE: BEYOND STUDENT LOANS *by Elizabeth A. Barrett, MA, CFP® Plantation, FL*

**T**alk to a parent about paying for college, and chances are you'll soon be discussing student loans. But your options go far beyond borrowing at the time your child enters school. Numerous possibilities are available to save in advance of college and to win scholarships.

What's your best college savings option? Most ACA advisors follow the rule to save in the most efficient place now and spend from the most efficient place later. Because tax laws and our lives are always changing, it's dangerous to conclude that any one option is the best place to save for something that's 10 or 20 years down the road.

Often the best place to save for a child's college education is the parent's Roth IRA, if the parent is eligible. There are several advantages:

- The savings grow tax deferred, and the contributions can be taken out without penalty.
- The money stays in the parent's name, where it remains in the parent's control and typically has a smaller impact on college financial aid awards.
- Money in the Roth IRA can be used for various family members' college expenses.
- When money is withdrawn for college expenses, the Roth's earnings may be taxable but are penalty free.
- And of course, the funds may be needed for retirement instead of college. (Like many ACA planners, I remind clients that children can always borrow to go to college, but their parents can't borrow for retirement.)



If Roths aren't an option for parents, either because they have already maxed out their contributions or aren't eligible, the next choice may be a Roth in the child's name. If children have earned income, they can make a Roth contribution, which can later be used for their college education. And if the Roth isn't used for college, teenagers have either college money for their own little ones in the future or for the down payment for a house. (Or maybe you'll enjoy a fun golf partner because with such an early start, your child may retire by age 40!)

Another option is a Section 529 plan or Qualified Tuition Program. The donor (usually a parent or grandparent) makes a contribution into a Section 529 plan and investments are purchased within the plan, much like a 401(k). Investment options vary by state. The earnings are tax deferred until the money is withdrawn and then taxed at the beneficiary's tax rate (probably no more than 15%). A 10% penalty is imposed if the funds are not used for college education, but only the *earnings* are penalized. If a grandparent or parent has an estate tax problem, they can reduce their liability with a contribution to the beneficiary's 529 plan. This is considered a "completed gift," so it's no longer in the grandparent's or parent's taxable estate.

Section 529 plans differ from other college savings options in many significant respects:

- Unlike Roth IRAs or other options, Section 529 plans aren't subject to income limits: you can contribute no matter how much you earn.
- Unlike certain prepaid plans, you can invest in another state's plan, and the student can go to school in any state.
- Unlike UTMA (Uniform Transfers to Minors Act) accounts (custodial accounts), the donor maintains control and ownership, so if your oldest child doesn't attend college, you can use the account to pay for another child's (or other relative's) college expenses.

The proceeds of a Section 529 plan can be used not only for tuition but also for books and room and board. (If the child lives at home, he can pay a room and board allowance

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## FINANCIAL STRATEGIES FOR EVERYDAY LIVING

### ALL ABOUT STRIPS

by Stewart Farnell, Ph.D., CFP® Boulder, CO

**B**onds called *Treasury Strips* have buttressed many portfolios during the recent stock market downturn. As fear replaces greed as the driving force in the market, panicked investors are seeking safety, and one of the safest investments is a U.S. Treasury bond. Investors compete to buy these bonds, driving up their price. This is normal when the economy is moving toward deflation. A key reason for owning Treasury Strips is to protect portfolios in deflationary times.

Strips are modifications of regular Treasury bonds. Regular Treasuries consist of two components. The *principal component* is a promise to pay a fixed sum at a fixed maturity date (e.g., to pay the bond's owner \$10,000 on May 15, 2024). The *interest component* is a promise to pay a fixed amount of interest every six months until the bond matures. Treasury Strips are regular Treasuries whose principal and interest components have been split and sold separately. For example, if you want a \$10,000 Treasury Strip, you can buy just the principal component of a regular \$10,000 Treasury bond. The interest components will be sold to other investors. Think of a Treasury Strip as a regular Treasury bond with its interest components "stripped" away.

Thus Treasury Strips pay no interest. The buyer of a \$10,000 Treasury Strip gets only a promise of \$10,000 at a certain date, backed by the full faith and credit of the U.S. Treasury. In the absence of interest payments, buyers of Strips benefit from a reduced purchase price. You might buy a \$10,000 Treasury Strip maturing in 2024 and pay only about \$6,200.

Treasury Strips provide safety of principal: the U.S. Treasury has never defaulted on a bond obligation, and Treasury securities are generally considered safer than AAA-rated corporate bonds. They are inexpensive to buy, and once bought, there is no further cost, assuming you hold the Strip to maturity.

For retirees, Treasury Strips can fill the gap between expected income and expected expenses. If you expect to retire in 2014 with annual expenses of \$52,000, along with Social Security and pension income of \$42,000 per year, you can buy Treasury Strips maturing every year for 15 years, each with a maturity value of \$10,000. The \$10,000 per year from your maturing Strips, plus the \$42,000 from your Social Security and pension, will cover your expenses.

Because Treasury Strips pay just the principal amount at maturity, covering this income gap costs less with Strips than with regular Treasuries. Strips sell at a discount to their value at maturity so a portfolio of 15 Strips, one maturing in each of the next 15 years for \$10,000 each, would currently cost about \$119,000. A ladder of regular Treasury securities with the same maturity dates would cost far more because they pay periodic interest as well as the return of principal.

Strips can pose one tax complication. Although they don't pay interest, the IRS treats them as if they do. According to the tax code, the spread between what you pay for the Strip and what you receive at maturity—your profit—is really interest in disguise. So each year you must report a portion of that profit as if it were income. For this reason, many ACA members advise their clients to hold Treasury Strips in retirement plans like traditional IRAs and 401(k)s, which shelters the income received from taxation every year. The tax is payable on the taxable value only when it is withdrawn from the account.

U.S. Treasury Strips aren't right for everybody. But for many clients of ACA members, Strips can be a reliable way to close the income gap in retirement. And with enough years of Treasury Strips in their portfolio, investors can afford to wait for their equity investments to recover, reducing the chance of having to sell them at a loss. ■ ■ ■



### PAYING FOR COLLEGE: BEYOND STUDENT LOANS

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specified by the school to Mom and Dad.) And if your scholar receives a full tax-free scholarship, the money can be taken out without incurring the 10% penalty.

Not all Section 529 plans are created equal. Ask your ACA advisor for help identifying the best plan for you and your beneficiary.

A related college savings option is the Upromise Credit Card ([www.upromise.com](http://www.upromise.com)). When you make purchases at any of more than 8,000 restaurants or 600 online retailers or you buy eligible items at the grocery or drugstore, a cash-back percentage is directed into your Upromise account, which you can then use to fund a Section 529 plan or to pay college expenses or a student loan.

Of course, just about the only thing better than saving in

advance for college is going to college for free. Websites such as [www.Fastweb.com](http://www.Fastweb.com) and [www.Collegeboard.com/ScholarshipSearch](http://www.Collegeboard.com/ScholarshipSearch) can help you search for a fit between the student and any of thousands of available scholarships totaling over \$1 billion. (One caveat: such sites can be rife with ads and special offers, so be careful when filling in information and checking boxes.) Other sources of college aid information include [www.WiredScholar.com](http://www.WiredScholar.com), [www.FinAid.com](http://www.FinAid.com), [www.eStudentLoan.com](http://www.eStudentLoan.com), and [www.Scholarships.com](http://www.Scholarships.com).

Trying to decide among all your college financing options can be confusing. A call to your ACA advisor can help you determine which options are best for you and offer you the greatest chance of realizing not only your family's college dreams but your other goals as well. ■ ■ ■



### GOOD MONEY SENSE IN AN "I WANT IT NOW" SOCIETY

by Erin Baehr, CFP®, EA Shawnee-on-Delaware, PA

**M**y six-year-old niece asked for an iPod this past Christmas. Not some kid-sturdy version of a portable CD player, not an MP3 player, but specifically an iPod. She didn't get it (thanks to my sister-in-law's good sense). But the fact that she knew to ask for it—an expensive name-brand electronic device—astounded me.

Maybe it shouldn't have. Between what they spend themselves and what they convince their parents and grandparents to buy, American children have influence over nearly \$1 trillion each year. Naturally, the advertising industry is well aware of our kids' buying power. Like it or not, your children are a crucial marketing niche.

Of course, the marketer's dream can be our nightmare. Who hasn't experienced the shopping aisle meltdown of a child who thinks you are the meanest parent in the world for not letting him get that new toy he saw advertised on TV? How many of us have tried to reason with a teenage girl who very seriously believes her life will be ruined by wearing clothes purchased from the wrong store? If it seems like a losing battle, it's no wonder: the average child is exposed to 40,000 commercials each year, manipulated by some of the most astute minds in the business world. So it's also no surprise that our free-spending teens grow into young adults with poor financial habits and a skewed perspective about money and spending.

What does the future hold for young people who embrace a consumer lifestyle that can harm their long-term financial health? Constant exposure to the message that they deserve a fantasy lifestyle unfortunately leads many young adults to aspire to lifestyles their salaries can't come close to matching.

Here are some startling conclusions from a United Services Automobile Association (USAA) survey, *High School Confidential: An Inside Look at Teens and Money*:

- Teens—half of whom aren't earning their own paychecks—spend nearly as much in "fun money" every month as their parents do.
- One teen in five expects to earn \$60,000 or more at their first full-time job after high school or college.
- Nearly two thirds of teens expect to be millionaires in their 40s—or sooner.
- Forty-two percent of teens expect to retire by age 60.

Despite these findings, teens who learn good habits can become financially functional and successful. The present state of the economy presents an ideal teachable moment, allowing us to reinforce the lesson that our society, in many cases, is paying the price for living beyond its means. Use this opportunity to give your children an understanding of financial realities, and teach them to make responsible choices with money. For example, if your teen gets a pile of birthday money, you can explain

that without a plan, it could soon be frittered away. Help your kids realize they have choices about spending that money.

**They can share it.** One effective antidote for materialism is to stay mindful of the needs of others. Children exposed to the need around them in their community and the world at large have an easier time resisting that tempting pair of \$90 jeans. The feeling your kids will savor from realizing the importance of the charitable donation can't be matched by any material luxury. Of course, encourage your kids to be purposeful about their giving, deciding on an amount or percentage to give and where they would like to donate.

**They can save it.** Teach your children to save at least 10% of their income, whether they receive it from their allowance, gifts, or a job. Aside from the obvious benefit of building their savings, developing the habit of saving will encourage them to live within their means. Offer rewards for reaching milestones in their savings, such as a monetary match or a family outing.

**They can spend it.** Help your kids recognize the difference between needs and wants and then

choose their spending accordingly. We insisted on two rules when my kids first started making spending decisions: they had to wait at least a few days to make sure they'd still want the item, and they had to search for coupons and sales before buying anything. You could also have them list three other ways they could spend that money before they actually do. Of course, teach your kids to use credit responsibly. They will be inundated with offers of easy credit, and they must understand the real cost of that credit and the consequences for default. They also need to know the value of their credit score and how to protect it. Let them try out credit with a loan from you for something they want, and if they default, repossess what they've bought. Better to learn by losing a small item now than a car or a home when they're older.

**They can pay taxes with it.** Sooner or later, we all learn that along with the privilege of living in this great country comes the duty (and in many ways the privilege) of paying taxes. Don't wait for them to be disillusioned by the take-home amount of their first paycheck. Collect a "family tax" on their income, and use it for something to benefit the whole family, like a group activity.

Parents can take heart: you are still your children's greatest and most important teachers (despite what your teens may tell you). Don't let the only messages they hear about money come from others with an agenda. Take the time to communicate your financial values to your children. Reflect on your personal financial philosophy, and be clear with yourself about your values and what you want to model for your children. Despite the efforts of clever and powerful marketing, you can counter the influence of our consumer-crazed society effectively. ■ ■ ■





### ENJOYING SOLID BENEFITS FROM HOME RENOVATIONS

by Karen Folk, Ph.D., CFP® Urbana, IL

**H**ome renovation has changed in the last ten years or so. Fueled by huge gains in the price of real estate, homeowners used to tap home equity with little care because prices were expected to keep climbing, more than covering the cost of improvements.

Today, with the slowdown in real estate and the widening damage in the subprime loan market, it's common to see home prices falling, not rising. And lenders are often a lot choosier about who they do business with. So before considering a home renovation, make sure your financial house is in order.

**Start with your credit report.** If you're considering borrowing, make sure your credit report and payment records are in the best possible shape. As in most economic crises, lenders go from being permissive to squeamish in an instant, so even people with good credit are going to be closely scrutinized. Check your credit report—you can get all three of your credit reports (from Experian, TransUnion, and Equifax) once a year for free. You can order them at [www.annualcreditreport.com](http://www.annualcreditreport.com). Some suggest ordering them at staggered times throughout the year so you can catch potential errors in your report as they happen. Others recommend getting all three at once, so reviewing credit reports becomes only a once-a-year task. Reviewing your report can help you clean up any negative credit behavior like late bills or heavy credit card debt.

**See what kind of payoff your planned renovations will deliver.** During the housing boom, many people believed almost any renovation would offer big returns. It wasn't true then, and it's especially untrue now. Take time to figure out what renovations now have the best chance for return on investment. One good resource is *Remodeling* magazine's annual *Cost vs. Value* report (<http://www.remodeling.hw.net/2008/costvsvalue/national.aspx>). Many people find they won't recover their investment in a remodeling project. It's still OK to go ahead. Just renovate because it's going to bring you comfort or pleasure, not because you're expecting immediate profits. If you're not renovating for yourself, but for a potential buyer, remember that they may not share your taste. You may love those new custom kitchen cabinets, but they may offer you a lower bid for your home if they hate them and want to replace them.



**Know how long you'll need to stick around.** When you sell, remember that most married couples can exclude from their taxable income up to \$500,000 of gain, and most individuals filing single or married filing separately can exclude up to \$250,000. You must have owned and used your home as your principal residence for two out of the five years before the sale. The exclusion is generally applicable once every two years. However, if you are unable to meet the two-year ownership and use requirements because of a change in employment, health reasons, or unforeseen circumstances, your exclusion may be prorated.

**Beware the bump in property taxes.** More valuable property often leads to higher tax assessments. Make sure you can afford not only the cost of renovation but what you'll need to pay in higher property taxes.

**Don't forget applicable sales tax deductions.** If sales tax was imposed on a major renovation or if your state or locality imposes a general sales tax on the sale of a home or the cost of a substantial addition or major renovation, you may be able to deduct it. This alternative is particularly valuable in low-income-tax states, and the sales tax paid on the purchase of some large items including the purchase of a home or major addition can be added to the taxable amounts.

**Make sure your renovation leaves your home salable.** A discussion with a real estate agent can tell you what will add or subtract value. For instance, a big addition can take away from the value of a home if it's not aesthetically in line with the rest of the neighborhood. Obviously, any renovation that keeps your house on the market longer had better be worth it now because it may damage your sales prospects later.

The process of renovating your home is often disruptive. Many make the mistake of waiting until they're about to sell the house before making the improvements they've dreamed about for years. But don't forget, you're living there now. The most important renovations are often those you'll have the chance to enjoy. ■ ■ ■

*Karen Folk, CFP®, a member of the FPA and ACA, adapted this column produced by the Financial Planning Association, the membership organization for the financial planning community.*