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Developing a College Funding Strategy

Funding the cost of college tuition and related expenses for children is a common source of concern for parents and grandparents who worry about the ever-increasing costs of a college education in the United States. With the average cost of one year of tuition, fees, room and board at a four-year private college costing $46,950 for the 2017-2018 school year[1], it is no wonder that parents are concerned about saving enough to cover these costs-especially over four or more years of study.

BACKGROUND: HOW MUCH DOES COLLEGE COST?

Furthermore, planning for college expenses in the future with today's costs in mind is not adequate because, historically, the annual increase in the costs of college tuition and related expenses have been significant. For example, if we look back 10 years to the 2007-08 academic year, the average cost of one year of tuition, fees, room and board at a four-year private college in today's dollars (i.e. after adjusting for inflation) was $36,600. Contrast this with the $46,950 price tag ten years later, this represents a real increase of approximately 25%.[2]

U.S. College tuition, fees, room & board for full time undergraduates:

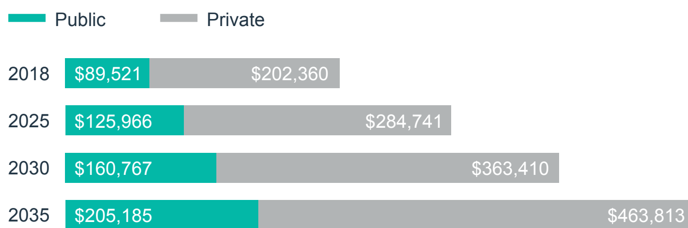
Average cost & percentage change in 10 year time period

	2017 Dollars (Adjusted for Inflation)		Actual (Not adjusted for inflation)	
Academic year	Public 4 Year College (In-state rate)	Private 4 Year College	Public 4 Year College (In-state rate)	Private 4 Year College
2007–2008	$15,930	$37,600	$12,700	$27,380
2017–2018	$20,770	$46,950	$20,770	$46,950
% change	30%	25%	64%	71%

Source: The College Board, 2017

Projected cost of four years of college:

Public and private colleges 2018-2035



Source: The College Board, 2017. Assumes college costs rise at 5% per year. Public college costs based on in-state rates.

KEY POINTS TO CONSIDER WHEN DEVELOPING A COLLEGE SAVINGS PLAN

College expenses can be daunting, however, it is important to remember that it is crucial to begin saving now even if it is not possible to save as much as desired due to competing priorities. The power of the financial markets, which have historically delivered returns over long time periods, as well as the principle of compounding, mean that starting sooner is better-even if the amounts saved may initially seem trivial.

Parents and grandparents may also wonder what proportion of a child's future college expenses will need to be provided by them versus financial aid such as scholarships, loans, and grants. Unfortunately, this cannot be known precisely in advance, especially for young children who might be almost two decades away from attending college.

"Rule of thumb" estimates as to what proportion of expenses a student or student's family must shoulder vary, with some on the high-end saying that parents need to save two-thirds of expenses while others think parents should expect to save as little as one-fourth and can rely upon a combination of scholarships, grants, and loans in addition to the parents' current income during their child's college education.[3]

While it is usually not possible to know if children will receive scholarships or grants in the future, it is helpful to know the reality of how current college students' educations are being funded. For example, according to the College Board's, "Trends in Student Aid 2017" report:

> *In 2016-17, undergraduate students received an average of $14,400 in aid per full-time student, including $8,440 in grants from all sources, $4,620 in federal loans, and $1,340 in a combination of tax credits and deductions and Federal Work-Study (FWS).[4]*

FINANCIAL AID

Many people believe they will not qualify for financial aid. However, according to the National Center for Education Statistics, 85% of full time undergraduate students received some form of financial aid for the 2015-16 school year.[5] The financial aid formulas are very complex and there are opportunities for even high income families to receive it. Also, the potential for receiving aid can increase for families who have more than one child attending college at the same time.

Keep in mind that guidelines change each year; however, based on these statistics, it is worthwhile to consider financial aid for most families. Even if a family does not qualify for aid this year, they may qualify for some level of financial aid in the future.

The topic of college student financial aid is a complex one and a full discussion is beyond the scope of this paper, however some important things to be aware of include:

- **Start early:** Consider learning about the financial aid application process as early as the child's sophomore year of high school in order to get familiar with the process and even potentially reposition assets or income.

It also makes sense to take advantage of the college planning resources provided by a child's high school.

- **FAFSA and PROFILE:** The main application for student financial aid is the Free Application for Federal Student Aid (FAFSA) which is used to apply for federal and state student grants, work-study, and loans. The FAFSA and additional information about financial aid is available via the FAFSA website at: www.fafsa.ed.gov.
- Generally speaking, the FAFSA is completed as early as October of the calendar year prior to the year the student will begin college and the deadline for that application is typically the end of June of the next calendar year. It is generally advisable to complete the FAFSA as early as possible.
- In addition to applying for federal aid, students can complete The College Scholarship Service Financial Aid Profile (PROFILE), which is the financial aid application service of the College Board. PROFILE differs from the FAFSA in that it determines your eligibility for non-federal financial aid that comes directly from colleges - including private institutional grants, scholarships, and loans. Through this application process, approximately 400 colleges, universities, graduate and professional schools, and scholarship programs determine eligibility for private (nonfederal) student aid funds. A PROFILE application may not be necessary-especially for students planning on attending public colleges or universities.
- **Inclusion Rate for FAFSA Applications:** Colleges assume children can contribute 20% of their savings/assets to their education (inclusion rate) and assume that parents will contribute up to 5.64% of their savings/assets. For this reason, parents and their financial advisors may determine it is advantageous to have assets titled in the name of the parents whenever possible.

For additional information on student financial aid for college, the U.S. Department of Education provides resources on its website: studentaid.ed.gov

COLLEGE SAVINGS OPTIONS

Before presenting various college savings vehicles, it is worth noting that when choosing how to save for college, tax consequences should be part of the decision. For example, should all of the college savings be held in a tax-advantaged account, for example a 529 Savings Plan? It may be more advantageous to use a combination of taxable and tax-advantaged strategies to meet these savings goals.

A good rule of thumb could be to save one-third in a tax-advantaged account, one-third in a taxable account and anticipate one-third to be paid for by grants, scholarships, gifts and loans. However, given the uncertainty of a child qualifying for grants or scholarships and the uncertainty of gifts and loans, it may be advisable to save enough in a taxable account to match these anticipated contributions, should they not come to be. By saving this amount in a taxable account, the family can avoid any penalties to which they may have been subject in a tax-deferred plan. This added savings could be used to pay for non-qualified expenses such as off-campus housing and basic living expenses.

To encourage families to begin saving early for post-secondary education for their children, various tax-advantaged savings plans have been put into place. No matter the strategy or investment vehicle chosen, the following characteristics should be considered:

- Potential for growth
- Risk of loss
- Tax implications
- Ownership and control
- Ease of management
- Fees and expenses

For families who begin saving early, there can be greater flexibility in the type of savings plans available and the amount of risk that can be assumed. The following is an overview of the various tools available, along with the impact on financial aid and tax incentives, if any.

Qualified Higher Education Expenses

As explained in the following sections, various college savings plans are available that allow for savings to grow tax-deferred and for tax-free distributions provided the funds are used for specifically defined expenses related to attending a college or university. These are referred to as "qualified higher education expenses". For tax-advantaged college savings plans, any distributions used to pay for the following are generally not subject to tax:

- Tuition
- School fees
- Books
- Supplies
- Computers (including software and internet access fees)
- Room and board (must attend at least-half time)

529 Savings Plans

529 Savings Plans are sponsored by each state (all 50 states offer 529 Savings Plans) and are the more popular type of Section 529 programs. Although these plans are sponsored by the state, they are usually managed by financial service companies. Some are offered through advisors only, while others are sold to consumers directly. The fees associated with these funds, investment options, risk of loss, and tax implications should be considered when choosing which 529 is most appropriate.

Account owners of 529 Savings Plans can choose from a range of investment portfolios, including allocations that automatically change as the beneficiary ages, offering higher risk in the early phases of saving, and becoming more conservative as the child approaches college age. There is no guarantee of the investment. Because these plans are sponsored by each individual state, they can vary greatly.

The following are features of 529 Savings Plans.

- They offer the opportunity to make larger contributions than other college savings plans such as the Coverdell Education Savings Account. Under these guidelines, there are no contribution limits. However, as described more fully below, there are limits to the annual gift tax exclusion, and many states impose a total contribution limit of $250,000. Typical guidelines are that no beneficiary should have a savings of more than the amount considered reasonable for college expenses.
- There are no income limitations for the owner of the plan, creating tax-advantaged savings options for wealthy families.
- The owner can change beneficiaries without losing tax-exempt status.
- They provide an opportunity to "superfund" the plan by using up to five years of the currently allowable $15,000 per donee/per donor annual gift-tax exclusion, which is $75,000 (or $150,000, using gift splitting by spouses), to jumpstart the plan. The ability to "superfund" a 529 plan could, through compounding, allow earnings to grow much faster. By doing this, individuals are precluded from making annual gifts to these donees for up to five years. If the individual dies before the end of the five years, a pro-rated amount of the gift will come back into the estate.
- They can benefit students of all ages, covering all eligible colleges, universities and other post-secondary institutions.

Financial Aid Impact: 529 Savings Plans are generally considered to be an asset of the parent(s) for FAFSA financial aid purposes. 529 plans owned by grandparents are not reportable on the FAFSA.

It is important to note that while distributions from 529 plans owned by parents are not considered income to the beneficiary that is not the case with distributions from 529 plans not owned by parents, such as a 529 plan account owned and funded by a student's grandparents. Grandparents should understand that if they

make distributions from such a plan for the benefit of a grandchild, it will be considered income received by the student in the year it was received and this would generally act to decrease the amount of financial aid awarded to the student.

One way to avoid distributions from a grandparents' account being included in the student's income for financial aid purposes is for the distributions to be used to fund the student's junior and senior year of college only (assuming a 4 year undergraduate timeline). Since there is a two year lookback, financial aid for an undergraduate's junior and senior years will be based on the student and parents' assets and income during that student's freshman and sophomore years, respectively. If grandparents' distributions begin in the student's junior year of college and continue in senior year, financial aid will not be impacted.

Tax Incentives: There is no federal tax deduction for contributions to 529 plans, although some states offer deductions for their own state plans. The growth of assets within these funds is not taxable, as long as the distributions are made for qualified higher education expenses. Distributions that are not for such qualified expenses will be subject to federal tax and may be subject to fees or penalties that vary by state.

529 Prepaid Tuition Plans

A 529 Prepaid Tuition Plan is established by a state (not available in all states) or by one or more eligible educational institutions, including eligible private education institutions, which allow participants to purchase tuition credits for qualified higher education expenses. 529 Prepaid Tuition Plans offer the opportunity for parents to lock in tuition at today's average cost. One benefit of this type of plan is that it offers a simple, effective way to prepay for a child's college.

These plans are operated by state governments and offer rates of return on the investment higher than most savings accounts and certificates of deposit. This type of plan offers no risk to principal and is often guaranteed by the full faith and credit of the state.

If the child ends up attending a private school or school outside the plan's eligible schools, these funds will typically pay the average of in-state public college tuition and the family will be responsible for any difference.

There are no income limits and contribution limits vary by state. The account owner maintains control of the account and can change the beneficiary, although many states require the beneficiary be a resident of the state.

Financial Aid Impact: As with the 529 Savings Plan, 529 tuition plans should be considered an asset of the parent if the parent is the account owner. If the student is the account owner the assets of this custodial 529 plan are not included in expected family contribution (EFC) in the federal financial aid formula, and therefore do not impact the financial needs analysis process.

Tax Incentives: There is no federal tax deduction for contributions to 529 plans. Because this is a prepaid program, the implied growth of these funds is not taxable, as long as the distributions are made for qualified higher education expense. Distributions that are not for such qualified expenses will be subject to federal tax and may be subject to fees or penalties that vary by state.

Coverdell Education Savings Accounts

A Coverdell Account is a trust or custodial account that enables money to be saved toward qualified educations expenses of a designated beneficiary. What sets the Coverdell Savings Accounts apart from other education savings vehicles is that funds distributed from the account may be used to pay for not only qualified college expenses but also elementary and high-school qualified educational expenses such as tuition without incurring taxes on the distributions provided such distributions do not exceed the cost of qualified education expenses incurred.

Some specific characteristics of the Coverdell ESAs are:

- Contributions are limited to $2,000 per beneficiary from all sources per year. Any contribution amount over $2,000 is subject to a 6% excise tax.
- Contributions are phased out for those with incomes between $95,000 and $110,000 for single filers and between $190,000 and $220,000 for married couples filing jointly. This phase out could be bypassed by gifting the contribution to the child through an UGMA/UTMA and allowing the child to make the contribution.
- Contributions can be made until the beneficiary reaches 18; the money must be withdrawn by the time he or she reaches 30 years of age. If the funds have not been totally withdrawn by the time the beneficiary is 30 years old, the earnings will be taxed as ordinary income and subject to a 10% penalty. Please note that IRS rules allow account balances to be rolled over to the Coverdell account of a family member who is under age 30 without penalty.
- An individual may contribute to both a 529 plan and a Coverdell in the same year, but there may be gift tax implications if that individual gives more than $15,000 per beneficiary.

Financial Aid Impact: The Coverdell account, for purposes of financial aid, is considered an asset of the account holder. However, the Higher Education Reconciliation Act of 2005 added special treatment for education savings, including Coverdell accounts that specify "a qualified education benefit shall not be considered an asset of the dependent student for the purposes of determining need for federal financial aid."[6] If the account holder is the child and the child is not considered a dependent, there will be a greater impact than if the asset is held by a parent or dependent child. If the account is owned by a dependent student, the impact will be minimal.

Uniform Gift to Minors Accounts & Uniform Trust for Minors Accounts

UGMA and UTMA accounts, usually referred to by these acronyms, are custodial accounts in which the child is the account owner and the parent (or other adult) is named as custodian. As the owner, the child is responsible for any income tax on earnings as well as taxes when the account is liquidated. The custodian controls the account until the child is no longer a minor. At that point, the custodial relationship ends and the child gains control of the account.

Neither the donor nor the custodian can place any restrictions on the use of the money when the minor becomes an adult. At that time the child can use the money for any purpose whatsoever without requiring permission of the custodian. As a result, there is no guarantee the child will use the money for his or her education. Also, since UGMA and UTMA accounts are in the name of a single child, the funds are not transferable to another beneficiary.

Financial Aid Impact: For financial aid purposes, custodial accounts are considered assets of the student which means there can be a significant impact on financial aid eligibility. However, the Deficit Reduction Act of 2005 added another potential method of eliminating the negative financial aid impact of a custodial account. As outlined in the section below, effective July 1, 2006, custodial versions of 529 college savings plans, prepaid tuition plans, and Coverdell Education Savings Accounts are treated as the asset of the parent for federal student aid purposes when the student is a dependent student and are excluded from income. If the assets of the custodial account are rolled over into one of these three types of accounts the financial aid treatment is shifted from a student asset to a parent asset.

Converting UGMA/UTMA Accounts to 529 Plans

Since UGMA and UTMA accounts are taxable and do not defer or eliminate taxes on investment growth, it may make sense to transfer funds from such custodial accounts to a 529 Savings Plan. Here are some things to keep in mind:

- Deposits to an UGMA or UTMA account constitute irrevocable gifts to the named beneficiary; even though an adult custodian is required and controls the account until the beneficiary reaches age 18 (21 in some states), the account assets are owned by the minor beneficiary.
- If cash is transferred from an UGMA or UTMA to fund a 529 Savings Plan, the original ownership structure remains such that the child beneficiary will still gain full access to the assets of the account upon turning 18 or 21 years of age, depending upon the state. This also means that the beneficiary of the 529 cannot be changed, i.e. funds cannot be used for anyone other than the original beneficiary.
- The above means that it will be necessary to create separate 529 accounts if one is created with funds transferred from an UGMA/UTMA account and there is a desire to add additional contributions to a 529 Savings Plan above the amount of the UGMA or UTMA account; this will allow parents to retain control of the non-UGMA/UTMA funded 529 account in case there are concerns about the child using the money for something other than college or if it is desirable to change the beneficiary and use the 529 account funds for another family member's qualified higher education expenses.
- It is important to note that even though 529 Savings Plan accounts funded with assets from an UGMA or UTMA custodial account limit the parent or custodian's control of the assets, such accounts are not treated as belonging to the minor child beneficiary for purposes of federal financial aid for college and will generally result in more favorable financial aid for students because the 529 account is treated as an asset of the parents.

Traditional and Roth IRAs

Traditional IRAs are retirement savings vehicles that provide tax-deferred growth. One additional feature of the IRA is the ability to withdraw money for payment of qualified higher education expenses without incurring a 10% early withdrawal penalty. The qualified higher education expenses must be for the account owner, the account owner's spouse, children or grandchildren.

As with Traditional IRAs, the distributions from Roth IRAs used to pay qualified higher education expenses are exempt from the 10% early distribution penalty, as long as the expenses are for the account owner, the account owner's spouse, children or grandchildren.

With a traditional IRA, the full amount of the distribution is still subject to income tax. With a Roth IRA, the portion of the distribution that comes from contributions is tax-free, but the portion that comes from earnings is still subject to income tax if withdrawn before age 59½. (If the owner has reached age 59½ and has held the Roth IRA for at least five years, the entire distribution is tax free.) If the owner limits withdrawals from a Roth IRA to just the contributions, the entire withdrawal is tax-free.

While tapping into an IRA is an option, there are some important considerations, including:

- **You can borrow for college, but you can't borrow for retirement.** When money is removed from the IRA, the potential benefit of compounding is also removed. Consider this hypothetical example: an individual age 45 removes $20,000 from his Traditional IRA to pay for his child's first year of college. Had he used other resources for college expenses, and assuming he could receive an average return of 7% until age 65, the $20,000 would have grown tax-deferred to a value of $77,394 by that age, which equates to a lost opportunity cost of $57,394.
- Even though there is no penalty assessed on the withdrawal for education expenses, income tax will still be due in the year of withdrawal.

Financial Aid Impact: Funds in traditional IRAs are sheltered from the financial aid needs analysis, and therefore have no impact on financial aid eligibility. One potentially significant problem with this approach is the distributions count as parents' income on the following year's FAFSA, reducing eligibility for need-based financial aid.

See "Appendix A" at the end of this paper for a comparison chart of the various types of accounts that may be used to save for college expenses.

CONCLUSION

There is no exact science when it comes to putting together a college savings plan. Each family's individual circumstances must be considered when choosing a strategy. When developing a plan, however, it is important for families and their financial advisors to clarify their expectations and look closely at the various savings vehicles and their tax implications, as well as their impact on financial aid.

As with any investment strategy, a regularly-scheduled review process is also necessary, as tax laws and family situations continue to change. Making the college savings plan part of the annual financial review process is recommended.

1 "Trends in Higher Education. Trends in Higher Education Series"", The College Board, 2016

2 Annual Survey of Colleges; NCES, IPEDS Fall Enrollment data, The College Board, 2017

3 "How to Pay for College.", Kaitlin Pitsker, Kiplinger.com, 2017 & "The Smart Student Guide to Financial Aid", 2017.

4 "Trends in Student Aid 2017.", College Board, trends.collegeboard.org, 2017.

5 "Fast Facts.", IES National Center for Education Statistics, 2018.

Appendix A: Comparison of account types

Account type		
529 Savings Plan	**What is it?** Account is established and cash contributions are invested in mutual funds selected by parent or in a "target date" fund based on beneficiary's expected start of college; funds are sold and cash is distributed when needed by the student for college expenses.	**Tax Deferred Growth/Distributions?** Investments grow tax deferred in account. Distributions for qualified higher education expenses are not taxed.
	Contributions tax deductible? Certain states allow deductions of contributions for in-state residents; contributions are not deductible for federal income tax purposes.	**Contribution limits?** To avoid gift tax: $15,000 contribution per donor; can frontload up to 5 years-worth at one time: $75,000 per donor; $150,000 per married couple. Lifetime maximum varies by plan.
	Can the beneficiary be changed? Yes, to another member of the original beneficiary's family.	
529 Prepaid Tuition Plan	**What is it?** Cash contributions now buys credits for attendance at specific school(s) in the future-usually for state schools & in-state residents. Not available in most states. Restrictions apply if beneficiary decides to use credits to attend a school other than those designated by plan.	**Tax Deferred Growth/Distributions?** Distributions (of credits or cash equivalent) for qualified higher education expenses are not taxed.
	Contributions tax deductible? Certain states allow deductions of contributions for in-state residents; contributions are not deductible for federal income tax purposes.	**Contribution limits?** To avoid gift tax: $15,000 contribution per donor; can frontload up to 5 years-worth at one time: $75,000 per donor; $150,000 per married couple. Lifetime maximum varies by plan.
	Can the beneficiary be changed? Yes, to another member of the original beneficiary's family.	
Coverdell Education Savings Account	**What is it?** Tax-advantaged ccount where funds distributed may be used for elementary and high school expenses in addition to college expenses. Funds must be withdrawn no later than beneficiary's 30th birthday and subject to tax at that time.	**Tax Deferred Growth/Distributions?** Investments grow tax deferred in account. Distributions for qualified education expenses for elementary, high school, and college are not taxed.
	Contributions tax deductible? No.	**Contribution limits?** Total contribution limit of $2,000 per year from all sources.
	Can the beneficiary be changed? Yes, to another member of the original beneficiary's family.	
UGMA / UTMA Accounts	**What is it?** Custodial account technically owned by the minor but controlled by a custodian until beneficiary reaches age 18 and gains full control of account. Beneficiary is not obligated to use cash for college once reaching age 18-custodian loses control at that time.	**Tax Deferred Growth/Distributions?** Investment income and capital gains are taxable to the beneficiary (and parents above certain levels).
	Contributions tax deductible? No	**Contribution limits?** No.
	Can the beneficiary be changed? No. Assets in the account are the property of the minor beneficiary.	
Traditional IRA	**What is it?** Retirement account-parents can make distributions to fund child's college expenses without early withdrawal penalty (premature withdrawal ordinarily prior to age 59½)	**Tax Deferred Growth/Distributions?** Assets and income grow tax-deferred. Distributions are taxable as income to the account owner; distributions for qualified higher education expenses are not subject to the early withdrawal penalty ordinarily imposed on account owners under age 59½.
	Contributions tax deductible? Yes, subject to income limits.	**Contribution limits?** $5,500 annually
	Can the beneficiary be changed? N/A beneficiary relevant to death of owner, not distribution for student.	
Roth IRA	**What is it?** Retirement account-parents can make distributions to fund child's college expenses without early withdrawal penalty (premature withdrawal ordinarily prior to age 59½)	**Tax Deferred Growth/Distributions?** Assets and income grow tax-deferred. Distributions of capital gains are taxable if made prior to age 59½, no tax due after age 59 ½. Distributions for qualified higher education expenses are not subject to the early withdrawal penalty ordinarily imposed on account owners under age 59½.
	Contributions tax deductible? Contribution limits? No.	**Contribution limits?** $5,500 annually subject to income restrictions ($6,500 if you're age 50 or older).
	Can the beneficiary be changed? N/A beneficiary relevant to death of owner, not distribution for student.	

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