Retirement Plan
ANALYTICS

A Review of the College Savings Account Landscape

When deciding on which savings vehicle to use for funding a child's (or grandchild's) college education, a plethora of options are available. The most frequently used accounts are Coverdell Education Savings Accounts (ESA), 529 Plans, brokerage accounts, Roth IRAs, and UGMA/UTMA accounts. Each account provides unique benefits and downsides, so careful consideration should be given prior to making an ultimate selection.

One of the first priorities when choosing the most appropriate account should be account ownership. The various types of college savings accounts are each governed by very specific rules and regulations. The ownership of these accounts has significant tax and financial aid ramifications. When completing the Federal Application for Financial Aid (FAFSA) approximately 5.64% of non-excluded assets held in the name of a parent are expected to be used by the family in funding college. These assets will increase the "Expected Family Contribution" (EFC) and therefore potentially hinder the amount of financial aid received. However, assets held in the name of a student have an even greater negative impact, as students are expected to use 20% of non-excluded assets for college costs. Excluded assets include funds held in retirement accounts, home value (primary home only), cars, family owned business, life insurance, etc.

Assets can also be held in other family members names, such as grandparents, aunts, or uncles. If utilized correctly, these accounts can result in 0% of the value being considered as part of the expected family contribution while still allowing the full tax-deferred growth. However, withdrawals from these accounts can be classified as income, and as much as 50% of this "income" can be considered available funds to pay for college.

It is also important to note that the IRS allows a yearly tax-exempt gifting amount of $15,000 per year ($30,000 per year if married) without having to worry about filing additional tax forms or using any of the lifetime estate tax exemption amount.

Below is a brief overview of each type of account and the relative strengths and weaknesses provided:

1. An Education Savings Account (otherwise known as Coverdell ESA) is an investment account which offers tax free growth on the investments if withdrawals are used for qualified educational expenses. The primary downside to these accounts is the annual contribution limit of only $2,000 per year per beneficiary. Income limits are also in-place for these accounts, so the account holder would be unable to contribute if their income is over a certain threshold. Additionally, the account must be fully withdrawn by the time the beneficiary turns 30 years old. Assets held in these accounts are considered to belong to the account owner when applying for student financial aid.

2. Brokerage accounts are simply investment accounts that allow for the account owner to invest in the stock market. The assets within this account are held in the name of the owner until sold or gifted. Interest and dividends will be taxable to the owner of the account each year. These accounts provide for lower tax rates on investments held for one year or longer and for "qualified" dividends. Accounts owned by parents are considered "parental" assets, while accounts owned by grandparents would be considered as neither parental nor student assets.

3. Roth IRA accounts are designed to be used for retirement spending. They allow for the account owner to save money "after tax", and then allow for the money to grow tax deferred until retirement, when it can be withdrawn tax free. The annual savings limit is $6,000 for those under age 50, and $7,000 for those 50+ (with "earned income"). The ability to save to a Roth IRA is also "phased out" depending on income. Roth IRAs allow for the account owner to withdraw their "basis" (the amount they have contributed) completely tax and penalty free at any point. So, a Roth IRA owner could save money to

a Roth IRA and take withdrawals from the "basis" in the account and use this towards college expenses. The owner could also withdraw the growth from the account tax-free if they were over age 59.5 and had opened the account at least 5 years prior. Retirement accounts are exempted from the student aid calculation, so money saved in a Roth IRA would not impact student financial aid. However, withdrawals from a Roth IRA would be counted as income to the account owner, which could negatively impact the financial aid calculation if the account is owned by the student or parent of the student. This includes withdrawals of "basis" (previous contributions) to the account, even though these withdrawals are tax-free.

4. Uniform Gift to Minors Act and Uniform Transfer to Minors Act (UTMA/UGMA) accounts are established for the benefit of a minor. When the minor reaches the age of majority (age 18 or 21, depending on the state), these accounts are legally transferred into the beneficiary's ownership. The accounts can be invested just like brokerage accounts. Using this type of account provides a level of risk since there is no guarantee that the beneficiary will use the account for educational expenses once they have full ownership of the account. Additionally, this money is counted as an asset of the student when applying for college aid, which is approximately 4 times worse compared to assets held in the name of a parent. Taxes due for this account are also due at the parent's income tax rate on earnings in the account over $2,200 a year.

5. 529 Plans are offered by each state and some states even allow for state income tax deductions for contributions. These accounts offer tax free growth on the investments if used for qualified educational expenses. These accounts also offer the ability to give 5 years' worth of the annual IRS gift tax exemption amount (currently $15,000 per year), or a total of $75,000 lump sum in one year, if desired. The donor would not be able to contribute again for the next 4 years if this strategy were pursued. Taxes and a 10% penalty are applied to any growth in the account withdrawn for non-qualified expenses. These accounts can be transferred to other related beneficiaries if desired. 529 accounts opened by a parent are considered a "parental" asset, so only 5.64% of the assets are expected to be used for college in the EFC calculation. For accounts opened by a grandparent or other family member, the assets are not included in the EFC calculation. However, any distributions to the student would count as "income" and could negatively impact the EFC calculation. More information is included below regarding 529 accounts.

Before taking on the cost of college for a child, you should ensure that you are on track for retirement. You can always take a loan out for college, but you can never take out a loan for retirement. Prior to taking on a child's college costs you should also ensure that you have no high interest debt and have a fully funded emergency fund with 3-6 months' worth of living expenses.

For those who live in states which do not offer an income tax deduction for contributions to 529 accounts, the following are some of the most highly rated 529 accounts for consideration. You do not need to live in the following states to take advantage of their 592 plans. Additionally, the money in these plans can be used for educational expenses across the US, not just in the state where the 529 is located.

- New York's 529 offers simple account setup, flexible use for you or your beneficiary, and low-cost investment options. There is no minimum account balance, and the account owner can setup automatic contributions. This encourages regular saving to build a balance for your beneficiary over a longer time horizon. There are no advisor fees, commissions, or account maintenance fees, which other plans may charge. The recordkeeping and related services for the Direct Plan are managed by Ascensus and the professional investment management is provided by Vanguard. Anyone can contribute to an account via a Ugift link. This assigns the account a serial number which can be used by friends and family to easily contribute to the account!

- Ohio's 529 is also easy to setup, provides flexible benefits for the beneficiary, and is very low cost. When funding the account, there is a $25 minimum contribution amount when using the mutual funds offered, or $500 when using the bank option certificates of deposit. This plan also offers the ability to set up automatic contributions to build a balance over time. There is no enrollment fee or annual account maintenance fee. The state of Ohio adds an extra 0.02% as an extra fee on the account. The investments are offered by Vanguard and Dimensional Fund Advisors with the CD's offered through Fifth Third Bank. Ascensus maintains the recordkeeping and related services for the Direct Plan. They offer the ability for anyone to contribute to the account with Ugift, just like the New York 529.

- My529 is the Utah Educational Savings Plan, which is very similar to New York and Ohio. When funding the account there is no minimum and the account owner can set up automatic contributions to the account. There are no enrollment, application, or account maintenance fees. Investments are provided by Vanguard, Dimensional, and PIMCO. The FDIC insured accounts are held at Sallie Mae and U.S. Bank. The recordkeeping and related services are operated by the Utah Higher Education Assistance Authority. The accounts offer the ability for anyone to contribute through the Gift Program.

- The Vanguard 529 plan is offered as part of Nevada's 529 account offering. Vanguard offers low cost investments and management, while the administration is done by the office of the Nevada State Treasurer. If you have Vanguard accounts already, the 529 account will show up on your dashboard with your other investment accounts. This can be helpful for clients who want to limit the number of custodians they use for their investment accounts. Vanguard's 529 plans only offer Vanguard funds. The options include 3 age-based portfolios and 20 individual funds. These accounts also offer the ability for anyone to contribute to the account via Ugift. Vanguard provides the recordkeeping and investment platform for 529 plans with Iowa, Colorado, Missouri, and New York. These states have account minimums that range from $1 to $25.

For grandparent established 529 plans, it is essential to properly plan distributions in order to not risk losing financial aid. When a child files the Free Application for Federal Student Aid (FAFSA), a parent owned 529 account would count as a non-excluded parental asset, and the calculation would assume that 5.64% of this account would be used by the family for college expenses. If the student owns the 529 account, the calculation would assume that 20% of this account would be used by the family for college expenses. When a grandparent or other relative owns the account, it does not show up as an asset of the parent or child, and therefore 0% is assumed to be used towards college costs. However, a non-guardian owner needs to be careful regarding the timing of when distributions are made from the account and given to the beneficiary. For FAFSA purposes, 50% of these distributions will be counted as income to the student and will inhibit the students' financial aid eligibility. Since FAFSA is based on financial information from 2 years prior, distributions should not begin from a grandparent owned 529 until the student's junior year to avoid losing any financial aid. However, if the student is not on a 4-year graduation plan or the student plans on attending graduate school, then distributions would need to be delayed further.

Another planning issue is that 529 Plans only allow $10,000 to be used to pay off student loans. The owner will need to determine if it makes sense to lose financial aid or only partially pay off their loans and roll the rest of the account to another beneficiary.

Overall a 529 college savings account provides a very attractive option when saving for college. The previously mentioned accounts are all highly rated and offer low-cost investments and management. Additionally, they allow for friends and family to contribute to the beneficiary's account! Care consideration should be given prior to selecting and funding an account. To talk further with a professional about these matters, please contact Andrew Michael, a CERTIFIED FINANCIAL PLANNER™ professional who has researched the topic thoroughly and is ready to answer your questions. Andrew can be reached at 980-999-2120, or andrew@plan-analytics.com.