Tax-Advantaged Ways to Save for College

In the college savings game, all strategies aren't created equal. The best savings vehicles offer special tax advantages if the funds are used to pay for college. Tax-advantaged strategies are important because over time, you can potentially accumulate more money with a tax-advantaged investment compared to a taxable investment. Ideally, though, you'll want to choose a savings vehicle that offers you the best combination of tax advantages, financial aid benefits, and flexibility, while meeting your overall investment needs.

529 Plans

Since their creation in 1996, 529 plans have become to college savings what 401(k) plans are to retirement savings--an indispensable tool for helping you amass money for your child's or grandchild's college education. That's because 529 plans offer a unique combination of benefits unmatched in the college savings world.

There are two types of 529 plans--college savings plans and prepaid tuition plans. Though each is governed under Section 529 of the Internal Revenue Code (hence the name "529" plans), college savings plans and prepaid tuition plans are very different college savings vehicles. There are typically fees associated with opening and maintaining each type of account.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. As with other investments, there are generally fees and expenses associated with participation in a 529 savings plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated.

529 Plans: College savings plans

A 529 college savings plan is a tax-advantaged college savings vehicle that lets you save money for college in an individual investment account. Some plans let you enroll directly, while others require that you go through a financial professional.

The details of college savings plans vary by state, but the basics are the same. You'll need to fill out an application, where you'll name a beneficiary and select one or more of the plan's investment portfolios to which your contributions will be allocated. Also, you'll typically be required to make an initial minimum contribution, which must be in cash. 529 college savings plans offer a unique combination of features that no other college savings vehicle can match:

- *Federal tax advantages:* Contributions to your account grow tax deferred and are completely tax free if the money is used to pay the beneficiary's qualified education expenses. The earnings portion of any withdrawal not used for college expenses is taxed at the recipient's rate and subject to a 10 percent federal penalty.
- *State tax advantages:* Many states offer income tax incentives for state residents, such as a tax deduction for contributions or a tax exemption for qualified withdrawals. However, be aware that some states limit their tax deduction to contributions made to the in-state 529 plan only.
- *High contribution limits:* Most college savings plans have lifetime maximum contribution limits over $300,000.
- *Unlimited participation:* Anyone can open a 529 college savings plan account, regardless of income level.
- *Professional money management:* College savings plans are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios.
- *Flexibility:* Under federal rules, you can change the beneficiary of your account to a qualified family member at any time without penalty. And you can rollover the money in your 529 plan account to a different 529 plan once per year without income tax or penalty implications.
- *Wide use of funds:* Money in a 529 college savings plan can be used at any college in the United States or abroad that's accredited by the U.S. Department of Education and, depending on the individual plan, for graduate school.
- *Accelerated gifting:* 529 plans offer an excellent estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's college education. Individuals can make a lump-sum gift to a 529 plan of up to $70,000 in 2017 ($140,000 for married couples) and avoid federal gift tax, provided a special election is made to treat the gift as having been made in equal installments over a five-year period and no other gifts are made to that beneficiary during the five years.
- *Variety:* Currently, there are over 50 different college savings plans to choose from because many states offer more than

one plan. You can join any state's college savings plan.

But college savings plans have drawbacks too. You relinquish some control of your money. Returns aren't guaranteed--you roll the dice with the investment portfolios you've chosen, and your account may gain or lose money.

Coverdell Education Savings Accounts

A Coverdell education savings account (Coverdell ESA) is a tax-advantaged education savings vehicle that lets you save money for college, as well as for elementary and secondary school (K-12) at public, private, or religious schools. Here's how it works:

- *Application process:* You fill out an application at a participating financial institution and name a beneficiary. Depending on the institution, there may be fees associated with opening and maintaining the account. The beneficiary must be under age 18 when the account is established (unless he or she is a child with special needs).
- *Contribution rules:* You (or someone else) make contributions to the account, subject to the maximum annual limit of $2,000. This means that the total amount contributed for a particular beneficiary in a given year can't exceed $2,000, even if the money comes from different people. Contributions can be made up until April 15 of the year following the tax year for which the contribution is being made.
- *Investing contributions:* You invest your contributions as you wish (e.g., stocks, bonds, mutual funds, certificates of deposit) - you have sole control over your investments.
- *Tax treatment:* Contributions to your account grow tax deferred, which means you don't pay income taxes on the account's earnings (if any) each year. Money withdrawn to pay college or K-12 expenses (called a qualified withdrawal) is completely tax free at the federal level(and typically at the state level too). If the money isn't used for college or K-12 expenses (called a nonqualified withdrawal), the earnings portion of the withdrawal will be taxed at the beneficiary's tax rate and subject to a 10 percent federal penalty
- *Rollovers and termination of account:* Funds in a Coverdell ESA can be rolled over without penalty into another Coverdell ESA for a qualifying family member. Also, any funds remaining in a Coverdell ESA must be distributed to the beneficiary when he or she reaches age 30 (unless the beneficiary is a person with special needs).

Unfortunately, not everyone can open a Coverdell ESA--your ability to contribute depends on your income. To make a full contribution, single filers must have a modified adjusted gross income (MAGI) of less than $95,000, and joint filers must have a MAGI of less than $190,000. And with an annual maximum contribution limit of $2,000, a Coverdell ESA can't go it alone in meeting today's college costs.

Custodial Accounts

Before 529 plans and Coverdell ESAs, there were custodial accounts. A custodial account allows your child to hold assets--under the watchful eye of a designated custodian--that he or she ordinarily wouldn't be allowed to hold in his or her own name. The assets can then be used to pay for college or anything else that benefits your child (e.g., summer camp, braces, hockey lessons, a computer). Here's how a custodial account works:

- *Application process:* You fill out an application at a participating financial institution and name a beneficiary. Depending on the institution, there may be fees associated with opening and maintaining the account.
- *Custodian:* You also designate a custodian to manage and invest the account's assets. The custodian can be you, a friend, a relative, or a financial institution. The assets in the account are controlled by the custodian.
- *Assets:* You (or someone else) contribute assets to the account. The type of assets you can contribute depends on whether your state has enacted the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA). Examples of assets typically contributed are stocks, bonds, mutual funds, and real property.
- *Tax treatment:* Earnings, interest, and capital gains generated from assets in the account are taxed every year to your child. Assuming your child is in a lower tax bracket than you, you'll reap some tax savings compared to if you had held the assets in your name. But this opportunity is very limited because of special rules, called the "kiddie tax" rules, that apply when a child has unearned income. Under these rules, children are generally taxed at their parents' tax rate on any unearned income over a certain amount. In 2017, this amount is $2,100 (the first $1,050 is tax free and the next $1,050 is taxed at the child's rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support.

A custodial account provides the opportunity for some tax savings, but the kiddie tax sharply reduces the overall effectiveness of custodial accounts as a tax-advantaged college savings strategy. And there are other drawbacks. All gifts to a custodial account are irrevocable. Also, when your child reaches the age of majority (as defined by state law, typically 18 or 21), the account terminates and your child gains full control of all the assets in the account. Some children may not be able to handle this responsibility, or might decide not to spend the money for college.

U.S. Savings Bonds

Series EE and Series I bonds are types of savings bonds issued by the federal government that offer a special tax benefit for college savers. The bonds can be easily purchased from most neighborhood banks and savings institutions, or directly from the federal government. They are available in face values ranging from $50 to $10,000. You may purchase the bond in electronic form at face value or in paper form at half its face value.

If the bond is used to pay qualified education expenses and you meet income limits (as well as a few other minor requirements), the bond's earnings are exempt from federal income tax. The bond's earnings are always exempt from state and local tax.

In 2017, to be able to exclude all of the bond interest from federal income tax, married couples must have a modified adjusted gross income of $117,250 or less at the time the bonds are redeemed (cashed in), and individuals must have an income of $78,150 or less. A partial exemption of interest is allowed for people with incomes slightly above these levels.

The bonds are backed by the full faith and credit of the federal government, so they are a relatively safe investment. They offer a modest yield, and Series I bonds offer an added measure of protection against inflation by paying you both a fixed interest rate for the life of the bond (like a Series EE bond) and a variable interest rate that's adjusted twice a year for inflation. However, there is a limit on the amount of bonds you can buy in one year, as well as a minimum waiting period before you can redeem the bonds, with a penalty for early redemption.

Roth IRAs

Though technically not a college savings account, some parents use Roth IRAs to save and pay for college. In 2017, you can contribute up to $5,500 per year. Earnings in a Roth IRA accumulate tax deferred. Contributions to a Roth IRA can be withdrawn at any time and are always tax free. For parents age 59½ and older, a withdrawal of earnings is also tax free if the account has been open for at least five years. For parents younger than 59½, a withdrawal of earnings--typically subject to income tax and a 10% premature distribution penalty--is spared the 10% penalty if the withdrawal is used to pay for a child's college expenses.

But not everyone is eligible to contribute to a Roth IRA--it depends on your income. In 2017, if your filing status is single or head of household, you can contribute the full $5,500 to a Roth IRA if your MAGI is $118,000 or less. And if you're married and filing a joint return, you can contribute the full $5,500 if your MAGI is $186,000 or less.

Financial Aid Impact

Your college saving decisions can impact the financial aid process. Come financial aid time, your family's income and assets are run through a formula at both the federal level and the college (institutional) level to determine how much money your family should be expected to contribute to college costs before you receive any financial aid. This number is referred to as your expected family contribution, or EFC. Your income is by far the most important factor, but your assets count too.

In the federal calculation, your child's assets are treated differently than your assets. Your child must contribute 20 percent of his or her assets each year, while you must contribute 5.6 percent of your assets. For example, $10,000 in your child's bank account would equal an expected contribution of $2,000 from your child ($10,000 x 0.20), but the same $10,000 in your bank account would equal an expected $560 contribution from you ($10,000 x 0.056).

Under the federal rules, an UTMA/UGMA custodial account is classified as a student asset. By contrast, 529 plans and Coverdell ESAs are counted as parent assets if the parent is the account owner. In addition, student-owned or UTMA/UGMA-owned 529 accounts are also counted as parent assets. For 529 plans and Coverdell accounts that are counted as parent assets, distributions (withdrawals) from the account that are used to pay the beneficiary's qualified education expenses are not counted as parent or student income on the federal government's aid form, which means that the money is not counted again when it's withdrawn.

However, the situation is different for grandparent-owned 529 plans and Coverdell accounts. If a 529 plan or Coverdell account is owned by a grandparent instead of a parent, the account isn't counted as a parent asset--it doesn't count as an asset at all.

However, money withdrawn from a grandparent-owned account is counted as student income, and student income is assessed at 50% in the federal aid formula.

Other investments parents may own in their name, such as mutual funds, stocks, U.S. savings bonds, certificates of deposit, and real estate, are also classified as parent assets. However, the federal government doesn't count retirement assets at all in its financial aid formula, so Roth IRAs aren't factored in to aid eligibility.

Regarding institutional aid, colleges generally dig a bit deeper than the federal government in assessing a family's assets and their ability to pay college costs. Most colleges use a standard financial aid application that considers assets the federal government might not, for example, home equity. Typically, though, colleges treat 529 plans, Coverdell accounts, UTMA/UGMA custodial accounts, U.S. savings bonds, and Roth IRAs the same as the federal government.