



# FINANCIAL PLANNING

## Financing Your Children's College Education

Steve Williams, CPA

**Saving for a child's college education involves much more than just opening a bank account for "someday." Depending on the investment vehicle you choose, there can be considerable advantages and disadvantages for your child—and for you.**

**M**ost parents are only too aware of the skyrocketing costs of college. Tuitions have nearly doubled in the past 20 years and they continue to rise annually. The good news is that there are now numerous funding vehicles available for college education, especially tax-advantaged investments and financial aid packages that can help as well.

### PLANNING

Before establishing a savings or investment account for your child's (or grandchild's) education, you must do some planning.

#### Defining Goals

Do you want to send your child to a public or private college? Have you already identified some possibilities? How much will these colleges cost by the time your child is ready to attend? Will the child finish in 4 years, or will it take

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longer? Will your child likely attend graduate school? Will your child be eligible for financial aid? The answers to these questions will help to determine the amount you need to save.

#### Determining the Time Frame

How old is your child? This will tell you how long the assets can accumulate before they are needed, and will also dictate the approximate annual investment required to meet your total funding goals. This amount in turn will indicate how aggressively you should invest these assets.

#### Selecting a Funding Vehicle

In today's sophisticated financial environment parents have a wide variety of college funding options. Take the time to study the pros and cons of each option and choose the one (or ones) best suited to your needs.

### INVESTMENT STRATEGIES

Many funding programs allow flexibility in investing. Using your goals and time frame you can evaluate the potential risk versus reward for any given program. For example, if your child has 5 to 15 years before reaching college age, you might choose longer-term, higher-risk investments (eg, stocks, mutual funds). As your child gets closer to college age, though, you should revisit your investment strategy and consider reallocating assets into less risky investments (eg, bonds, short-term securities).

All college funding programs should be evaluated on a case-by-case basis. Some parents must be very concerned with the tax implications of various plans, whereas others must be careful to select a plan that will not affect their

child's chances of obtaining financial aid. Still other parents must plan for the impact of college funding on other investments made for the child (eg, home down-payments, retirement).

The most common college savings plans are briefly explained here. If a particular plan appears to be the right choice for your situation, you should undertake further research to gain a better understanding of its strengths and weaknesses.

### Section 529 Plans

Named after Section 529 of the Internal Revenue Code, 529 plans have become more popular since the Economic Growth and Tax Relief

**Section 529 college savings plans are treated as an asset of the account owner (typically the parent), and thus have a low impact on financial aid eligibility.**

Reconciliation Act in 2001 made their earnings tax-free through 2010. Any US resident aged 18 years or older may invest in any state's plan.

**Tax Benefits.**—Section 529 plan earnings grow tax-deferred, and distributions for qualified higher-education expenses are federal income-tax-free. Thus, rather than investing money in a certificate

of deposit (CD) or taxable brokerage account for your child's college education, you can save it in a Section 529 account tax-free.

**Plan Options.**—There are two types of Section 529 plans:

- *Prepaid tuition plans* allow you to “lock in” future tuition rates at current prices, offering considerable peace of mind. Most of these plans have a better rate of return on investment than bank savings accounts and CDs.
- *College savings plans* provide more options, but do not offer a guaranteed tuition rate. Unlike prepaid tuition plans, there is no lock on tuition rates and no guarantee. Investments are subject to market conditions, and the savings may not be sufficient to cover all college costs. However, with this added risk comes the potential for earning greater returns.

**Use of Funds.**—Savings from Section 529 plans can be used for tuition, books, supplies, and equipment required for enrollment or attendance at an eligible higher-education

institution. Qualified institutions include most accredited 2- and 4-year colleges and universities, vocational-technical schools nationwide, and eligible foreign institutions.

**Investment Options.**—A key aspect of Section 529 plans is the professional management of the assets. The plan participant chooses from portfolio options that range from equity to fixed-income investments. Many Section 529 plans offer age-based portfolios that are managed according to risk parameters in conjunction with the targeted date for college entrance.

**Financial Aid Considerations.**—Section 529 plans vary in their impact on financial aid eligibility. Currently, prepaid tuition plans have a very high impact on financial aid eligibility. Prepaid tuition plans are treated as a resource, which means that they reduce need-based financial aid by 100%, yielding a dollar-for-dollar reduction in aid. Section 529 college savings plans are treated as an asset of the account owner (typically the parent), and thus have a low impact on financial aid eligibility. Distributions from a college savings plan are not counted as untaxed income or as a resource.

### Coverdell Education Savings Accounts

A Coverdell Education Savings Account (ESA) is a trust or custodial account created or organized in the United States for the sole purpose of paying the qualified education expenses of the designated account beneficiary. Coverdell ESAs allow federal-tax-deferred growth on any earnings, and federal-tax-free withdrawals for qualified education expenses.

**Establishing the Account.**—The trust or custodial account must be designated as a Coverdell ESA when it is created. Parents, grandparents, and other family members can set up Coverdell ESAs in your child's name. The designated beneficiary is the individual named to receive the funds when the account is established. The designated beneficiary must be under age 18 years or a special-needs beneficiary at the time the account was created.

**Qualified Education Expenses.**—In general, qualified education expenses are the funds required for the enrollment or attendance of the designated beneficiary at an eligible education institution. For the purposes of Coverdell ESAs, the expenses can be for either qualified higher

education or qualified elementary and secondary education.

**Contributions.**—If your modified adjusted gross income (MAGI) is less than \$110,000 (\$220,000 for a joint return), you may be able to establish a Coverdell ESA to finance the qualified education expenses of a designated beneficiary. For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return.

There is no limit on the number of separate Coverdell ESAs that can be established for a designated beneficiary. However, total contributions for the beneficiary in any year cannot exceed \$2,000, regardless of the number of accounts.

**Tax Benefits.**—Contributions to a Coverdell ESA are not tax-deductible, but funds deposited in the account grow tax-free until distributed. Distributions are tax-free if they do not exceed the beneficiary's adjusted qualified education expenses for the year.

**Investment Options.**—Coverdell ESAs let you invest in any combination of stocks, bonds, mutual funds, and exchange-traded funds (ETFs) to suit your needs.

**Financial Aid Considerations.**—Coverdell ESA accounts are considered an asset of the parent, not the child, resulting in a lower weighting in federal financial aid formulas.

### Custodial Accounts

Another common college savings vehicle is a Uniform Gift to Minors Account (UGMA) or a Uniform Transfer to Minors Account (UTMA). The funds can be used for college or other needs of the child. These accounts are considered the asset of the child, which means that he/she can decide how to use the funds (ie, irrevocable gifts).

**Account Set-up.**—The custodian, typically the child's parent or guardian, controls the account until the child reaches the age of majority (ranging from age 18 to 21 years, depending on the state).

**Tax Advantages.**—Custodial accounts offer some tax relief because part of the investment earnings may be exempt from federal income tax. Further, some or all of the earnings may be taxed at the child's tax rate.

**Investment Options.**—Investments can be made in mutual funds, stocks, bonds, and ETFs.

**Use of Funds.**—Assets held in UGMAs or UTMAs are considered irrevocable gifts, which means that after the child reaches the age of majority, he/she can use the assets for any purpose, not just educational expenses.

Of course, this is considered a drawback by many custodians because of the potential for the child to waste the funds, which is ultimately an issue of trust. However, responsible children have also found other means to pay for college expenses, then used custodial assets as down-payments on homes, so there are definite advantages to the flexibility in use of these assets.

**Financial Aid Considerations.**—Custodial accounts carry a higher weighting in federal financial aid eligibility formulas, which may reduce eligibility for financial aid. However, before dismissing custodial accounts as an option because of this detriment, you should calculate whether your child would receive financial aid in any case due to your income level.

• • • *a trust provides protection from the college student's creditors or ex-spouses.*

### Other Education Funding Options

**Trusts or Limited Partnerships.**—If you have a large estate and expect to transfer assets to your children or grandchildren in excess of the amount needed to fund college education, a trust or limited partnership can ensure that the funds will be used according to your wishes. Further, a trust provides protection from the college student's creditors or ex-spouses. For example, if your child marries during college and then divorces without having a prenuptial agreement, the ex-spouse can demand half of your child's assets if he/she is not protected by a trust.

Similarly, a limited partnership or limited liability company (LLC) is controlled by the general partner or managing member, and also provides asset protection.

**Withdrawals From Individual Retirement Accounts.**—Tax laws allow you to take an early withdrawal (before age 59.5 years) from your traditional or Roth Individual Retirement Account (IRA) to pay for your children's qualified higher education expenses. Although this will likely

result in paying income taxes on the amount withdrawn, money used for qualified education expenses is exempt from any tax penalty. This strategy is generally discouraged because IRA

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withdrawals have a negative impact on your savings for retirement.

**Loans From a 401(k) Plan.**—Investors in 401(k) plans can borrow from the plan to assist with college expenses. In general, either \$50,000 or half of the invested amount (whichever is less) may be borrowed. Although there are no special tax benefits

the loan amount is not subject to tax unless the owner defaults on the loan. Another benefit is that these funds are not considered to be part of the parents' assets for the purpose of determining financial aid. A possible disadvantage is that loans from a 401(k) plan may affect the borrower's ability to make additional contribu-

tions, and may mandate immediate repayment if the borrower is terminated from employment, changes jobs, or becomes disabled.

**Home Equity Loans.**—Some parents borrow against their home equity to fund college education. There are risks to this approach, including an unforeseen reduction in home value and increasing your debt at a later stage in life.

**EE Savings Bonds.**—Series EE bonds may provide certain tax advantages for education funding. The earnings on these bonds are exempt from state and local income taxes, and are federal income-tax-deferred if used for qualified higher education expenses.

#### CONCLUSION

Whichever investment strategy you choose, the sooner you start saving for your child's education, the better. Starting early not only provides more time to invest, but it also allows time for investments to grow through compounding of earnings. Even a modest amount invested on a regular basis can bring rewards in the long term.