Education Dreams Can Come True with Proper Planning

Few people question the value of a college education, but the cost of sending just one child to college for four years can be staggering. With the cost of higher education rising faster than inflation, parents of today's five-year-olds may face college bills of more than $200,000.

Higher Education Preparation

To make the dream of putting your children or grandchildren through college a reality, you need to have a plan for how you will save and a sensible investment strategy. Your child's college tuition could be one of the largest expenditures you ever make. And, if you have more than one child, the financial commitment is even greater. The financial challenge you face is shared by millions of others. Even if your goal seems overwhelming now, proper planning and saving can put the cost of any college within your reach.

Logically, the more money you save, the better your chances of meeting your education goals. In addition, to get the greatest benefit from the power of compounded returns, you must start saving as far in advance as possible.

There are a number of factors to consider before embarking on your college savings program and a range of investment options to sort through. The decision to hold the investment in your child's name or your name is significant because the method you choose can affect who controls the account, your child's eligibility for college financial aid, and the amount of taxes you will pay.

Investing in Your Name – Investing in your own name gives you maximum control over your college savings program assets. You decide when (if ever) your child gets access to the assets. There is a price for this control — you pay taxes on the earnings in the account at your marginal income tax rate.

Investing in Your Child's Name – Savings in your child's or grandchild's name may seem appealing because earnings are taxed at the child's (presumably lower) tax rate. However, tax provisions limit the appeal of this strategy. The standard deduction on unearned income for an individual claimed as a dependent is $1,050. Your child must pay taxes on any unearned income in excess of $1,050.

"Kiddie Tax" Rules – The "kiddie tax" rules can further limit the appeal of investing in your child's name. Prior to 2018, any unearned income in excess of $2,100 for a child under age 19 (or if a full-time student, under age 24), was taxed at the higher of his or her rate or the parents' top marginal tax rate. Beginning in 2018, the tax rate for trusts and estates will be used in place of the parents' tax rate.

Taxation of earnings can be deferred or eliminated completely by using certain tax-advantaged savings accounts like 529 education savings plans and Coverdell Education Savings Accounts. How you structure your education savings strategy can be as critical as how much you save. Your Benjamin F. Edwards financial advisor can help you examine these alternatives and help you decide which approach is best for you.

529 Education Savings Plans

A 529 education savings plan is a tax-advantaged savings plan sponsored by a state that is designed to provide tax-free savings for future education costs, specifically for K-12 tuition expenses at public, private or religious schools (up to $10,000 a year) and for a variety of qualified expenses at colleges, universities, or other post-secondary education institutions. It is named after Section 529 of the Internal Revenue Code which created these types of savings plans in 1996, along with 529 pre-paid college savings plans. Unlike 529 pre-paid plans which typically require residency and generally require you to attend an in-state college or university in exchange for pre-paying tuition today, 529 savings plans are generally open to anyone and can be used by the student at any educational institution they choose.

Each state determines the lifetime maximum amount you may accumulate per student, the investments, costs and the state tax incentives available for their plan. Keep in mind if you invest in your state's plan, you may also enjoy state tax benefits that may include a state tax deduction or credit for contributions as well as state-tax-free withdrawals.

Generally, qualified education expenses are those required for enrollment or attendance. These typically include tuition, fees, books, supplies, equipment, and in some circumstances, room and board, or special needs services required by a special needs student.

Earnings in 529 savings accounts are tax-deferred and grow free from federal and state taxes. Withdrawals for a student's qualified education expenses are also tax-free on your federal income tax return. The majority of states sponsoring 529 savings plans offer tax deductions or credits for contributions. Any withdrawals for purposes other than qualified education expenses will cause any earnings to be subject to federal income tax and possibly a 10% federal tax penalty. States may also require you to repay any state income tax deduction you received if you make a non-qualified withdrawal. This is generally referred to as a "recapture tax".

There are no income or age limits. You can open a 529 savings plan for anyone— your child, grandchild, niece, nephew, friend or even yourself. In most cases, multiple people can contribute to the same 529 savings account, for example, parents, grandparents, aunts, uncles or family friends.

The only limit placed on contributions to a 529 savings plan is a "lifetime limit" which is set by each state sponsoring a plan. This limit is meant to keep individuals from dramatically overfunding college savings beyond what is realistically needed. Contributions are considered gifts and are subject to gift tax rules which require you to file a gift tax return for gifts over $15,000 to anyone besides your spouse (married couples can gift up to $30,000 a year to the same individual).

However, there is a special provision for 529 savings plans that allows five years of accelerated gifts, so married couples can contribute up to $150,000 in one year per student; single tax payers can contribute up to $75,000 per student. Any additional gifts given to the student in the current and following four years, including additional contributions to the 529 savings plan, could trigger gift tax consequences in the years the gifts are made.

The account owner, usually the contributor, remains in control of the 529 savings plan and can change beneficiaries at any time without penalty provided the new beneficiary is a member of the previous beneficiary's family. If you have saved for your child's college education and they won't be attending college, changing the beneficiary gives you an option to use the 529 savings account for other children, nieces or nephews, yourself or your spouse, or other eligible members of the family.

529 education savings account balances can also be rolled over to a 529 ABLE account in the event your child becomes disabled. ABLE accounts, or Achieving a Better Life Experience accounts, are also state-sponsored plans that provide tax-advantaged savings for disability-related expenses for individuals who became blind or disabled prior to the age of 26. Beginning in 2018, amounts up to the annual ABLE contribution limit are eligible for rollover from a 529 education savings account for the same designated beneficiary or a disabled family member.

Coverdell Education Savings Accounts (ESAs)

The Coverdell ESA (formerly known as an Education IRA) helps families save for education in much the same way a Roth IRA helps individuals save for retirement. The after-tax dollars deposited into an ESA have the opportunity to grow and be withdrawn tax free, as long as withdrawals are used to pay the beneficiary's qualified education expenses. ESAs can be used to save for any level of education — from elementary school through graduate school. Not everyone can fund an ESA. There are income limits that may exclude mid- to upper-income families.

ESAs allow eligible parents, family members, and students to contribute up to $2,000 per year (until the child turns age 18) toward qualified education expenses at any college, university, vocational, elementary, or secondary school. The beneficiary can only receive a total contribution of $2,000 in any given year, regardless of the number of contributors to that account. The $2,000 is considered an irrevocable gift (so it doesn't belong to you anymore and you cannot get it back once the contribution is made) and is a non-deductible contribution.

If there is a balance in the ESA when the beneficiary reaches age 30, it must be distributed within 30 days unless it is for a special needs student. At that point, earnings in the account will be taxable and subject to an additional 10% tax.

The beneficiary may avoid these taxes by changing the beneficiary or rolling over the account to a Coverdell ESA or 529 savings account for a family member.

Custodial Accounts (UGMA, UTMA)

Prior to the existence of 529 plans, the Uniform Gifts for Minors Act (UGMA) and the Uniform Transfer to Minors Act (UTMA) — also referred to as custodial accounts — were commonly used to save for college and transfer wealth to children and grandchildren. With custodial accounts, you appoint a custodian, for example yourself or another adult, to manage the investments and make distributions for the benefit of the minor. You can use custodial accounts to pay for education expenses, but you are not required to. Once you've transferred or donated assets into a custodial account, it is irrevocable. If the contributor acts as the custodian, he or she must act for the child's benefit and not for himself or herself.

Once the child reaches the age specified by his or her state of residence, the custodian's supervisory powers end and the child has control over the account. As a result, the child may choose not to use the money for college. The child pays taxes for income earned in the account. There may be other drawbacks, such as a "kiddie tax," (discussed above) where the earnings are taxed at higher rates than the child's income tax rate. If maintaining control of the assets yourself (even after the student has reached the age of majority) is important to you, consider investing in your own name or in a 529 savings plan rather than a custodial account.

Qualifying U.S. Savings Bonds

Issued by the U.S. Treasury and backed by the U.S. government, Series EE and Series I saving bonds are another option in education planning. You may use any sort of U.S. Treasury bonds, notes, and T-bills to pay for college expenses. Generally, you must pay federal income tax on interest earned on U.S. savings bonds.

Only Series EE and Series I savings bonds can be used to pay for qualified post-secondary education costs without having to pay federal income tax on the interest that you earned on the bonds. You can purchase as little as $25 or as much as $10,000 of each series (EE and I) each year. There are income requirements that may exclude upper-income families from realizing these benefits. A bond purchased in the name of your child or grandchild will not qualify for the interest exclusion.

When the bonds are purchased, the owner must be at least 18 years old on the first day of the month in which the bond(s) were bought. To qualify as an education savings bond, you must use the bonds for qualified education expenses for yourself, your spouse or a dependent for whom you claim an exemption on your federal tax return.

Traditional and Roth IRAs

Retirement assets such as traditional IRAs and Roth IRAs can also be used to meet eligible educational expenses for certain family members. Taxation of the IRA withdrawals will depend on the type of IRA and your individual circumstances.

Unlike Coverdell ESAs and 529 savings plans, distributions from traditional IRAs are generally taxable. However, if used for post-secondary qualified education expenses of certain family members, the additional 10% penalty tax for early distributions before age 59 ½ would not apply.

Roth IRA distributions may or may not be subject to income taxation. Roth IRA contributions can be withdrawn any time, for any reason, without causing a tax liability. Also, tax-free distributions are generally available after age 59 ½ if you have held the Roth IRA for at least five years. However, if you take a non-qualified Roth IRA withdrawal and use it for education expenses, it could create an income tax liability on any earnings distributed. The earnings, however, would not be subject to the 10% early withdrawal penalty if you are younger than age 59 ½ and they were used for your qualified higher education expenses or those of certain family members.

Using your retirement savings for college is certainly an option, but your long-term retirement goals may need to be adjusted if you withdraw retirement savings for education expenses.

Planning Your Investment Strategy

When looking for ways to build your child's education funds, consider the following strategies:

Review the income and estate tax savings benefits of 529 savings plans. If you are able to make substantial contributions toward your child's or grandchild's education expenses, your first choice may be to fund a 529 savings plan by taking advantage of the accelerated gifting ability. By using these benefits, you will be able to contribute substantial amounts to the 529 savings plan and potentially take advantage of federal income tax-free distributions. However, keep in mind that, depending on the size of your gift, this may limit your ability to make nontaxable gifts to the beneficiary(ies) for a number of years. Your Benjamin F. Edwards financial advisor can explore the gift and estate tax consequences with you.

Determine whether you're eligible to contribute to a Coverdell ESA. If you're eligible, take advantage of the tax-deferred savings that Coverdell ESAs offer. Keep in mind, however, that the $2,000 per year annual contributions alone probably won't be enough to meet your college expense needs but may help with elementary or high school expenses. Note: You can contribute to both a 529 savings plan and a Coverdell ESA in the same year for the same beneficiary if you are eligible.

Understand the impact education savings has on eligibility for college financial aid. The FAFSA looks at assets and income of dependent students and their parents to calculate the Estimated Family Contribution (EFC). Many colleges and universities require the completion of the FAFSA and use the EFC to determine need-based financial aid awards. In general, assets and income of a parent impact the EFC more favorably than assets and income of a student.

529 education savings plans and ESAs are generally treated as an asset of the parent if the parent is the account owner. If a grandparent is the account owner, the assets won't be counted in the EFC until 529 savings plan withdrawals begin, and then they will be treated as student income. UGMAs and UTMAs are considered an asset of the student. Qualifying U.S. savings bonds are treated as an asset of the registered owner of the bond. Retirement accounts, like traditional and Roth IRAs, are not counted at all. Although, it's important to understand how your education savings impact the FAFSA, keep in mind that without your own savings the financial aid alone may not be sufficient to cover the rising costs of a college education.

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Talk To Your Financial Advisor

At Benjamin F. Edwards & Co., we want to develop and sustain client relationships built on trust, integrity, and mutual respect. Before you make an investment decision, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification needs and liquidity objectives with your financial advisor.

To learn more about the education planning options available to you, talk to your financial advisor today. ■

IMPORTANT DISCLOSURES

An investment in a 529 plan will fluctuate such that an investor's shares when redeemed may be worth more or less than the original investment. Investors should carefully consider a 529 plan's investment objectives, risks, charges and expenses before investing. This and other important information can be found in the 529 plan issuer's official statement, which should be read carefully before investing. Benjamin F. Edwards & Co. is not a tax advisor. Please consult your accountant to discuss the tax implications of the products discussed in this report before investing. In providing this information to you, neither Benjamin F. Edwards & Co. nor our financial advisor, is acting as a "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) and it should not be considered individualized investment advice or an investment recommendation. Due to the scope and complexity of the tax law changes enacted in December 2017, it is expected that the IRS will be providing additional guidance over the coming months. Technical corrections and additional clarification are common in such situations, and if any are issued, we will update our client materials and resources accordingly. However, given the possibility of updated guidance and corrections to the tax law, it's important that any questions about your individual tax situation be directed to your tax professional.