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 than 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 saving money for a child's or grandchild's college education. That's because 529 plans offer a unique combination of benefits.

There are two types of 529 plans—savings plans and prepaid tuition plans. Though each is governed under Section 529 of the Internal Revenue Code (hence the name "529" plans), savings plans and prepaid tuition plans are very different savings vehicles.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing; specific plan information is available in each issuer's official statement. There is the risk that investments may not perform well enough to cover college costs as anticipated. Also, before investing, consider whether your state offers any favorable state tax benefits for 529 plan participation and whether these benefits are contingent on joining the in-state 529 plan.

Other state benefits may include financial aid, scholarship funds, and protection from creditors.

529 Savings Plans

The more popular type of 529 plan is the savings plan. A 529 savings plan is a tax-advantaged savings vehicle that lets you save money for college and K-12 tuition in an individual investment-type account, similar to a 401(k) plan. Some plans let you enroll directly, while others require you to go through a financial professional.

The details of 529 savings plans vary by state, but the basics are the same. You'll need to fill out an application, 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 made in cash.

529 savings plans offer a unique combination of features that no other education savings vehicle can match:

Federal tax advantages: Contributions to a 529 account accumulate tax deferred, and earnings are tax-free if the money is used to pay the beneficiary's qualified education expenses. (The earnings portion of any withdrawal not used for qualified education expenses is taxed at the recipient's rate and subject to a 10 percent 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 plans have lifetime contribution limits of $350,000 and up (limits vary by state).

Unlimited participation: Anyone can open a 529 savings plan account, regardless of income level.

Wide use of funds: Money in a 529 savings plan can be used to pay the full cost (tuition, fees, room and board, books) at any college or graduate school in the United States or abroad that is accredited by the Department of Education, and for K-12 tuition expenses up to $10,000 per year.

Professional money management: 529 savings plans are offered by states, but they are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios.

Flexibility: Under federal rules, you are entitled to change the beneficiary of your account to a qualified family member at any time as well as roll over (transfer) the money in your account to a different 529 plan once per calendar year without income tax or penalty implications.

Accelerated gifting: 529 savings plans offer an estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's education while paring down their own estate or a way for parents to contribute a large lump sum. Under special rules unique to 529 plans, a lump-sum gift of up to five times the annual gift tax exclusion amount ($16,000 in 2022) is allowed in a single year, which means that individuals can make a lump-sum gift of up to $75,000 and married couples can gift up to $150,000. No gift tax will be owed provided the gift is treated 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.

Transfer to ABLE account: 529 account owners can roll over (transfer) funds from a 529 account to an ABLE account without federal tax consequences. An ABLE account is a tax-advantaged account that can be used to save for disability-related expenses for individuals who become blind or disabled before age 26.

Variety: Currently, there are over 50 different savings plans to choose from, because many states offer more than one plan. You can join any state's savings plan.

But 529 savings plans have a couple of drawbacks:

No guaranteed rate of return: Investment returns aren't guaranteed. You roll the dice with the investment portfolios you've chosen, and your account may gain or lose value depending on how the underlying investments perform. There is no guarantee that your investments will perform well enough to cover college costs as anticipated.

Investment flexibility: 529 savings plans have limited investment flexibility. Not only are you limited to the investment portfolios offered by the particular 529 plan, but once you choose your investments, you can only change the investment options on your existing contributions twice per calendar year. (However, you can generally direct how your future contributions will be invested at any time.)

529 Prepaid Tuition Plans

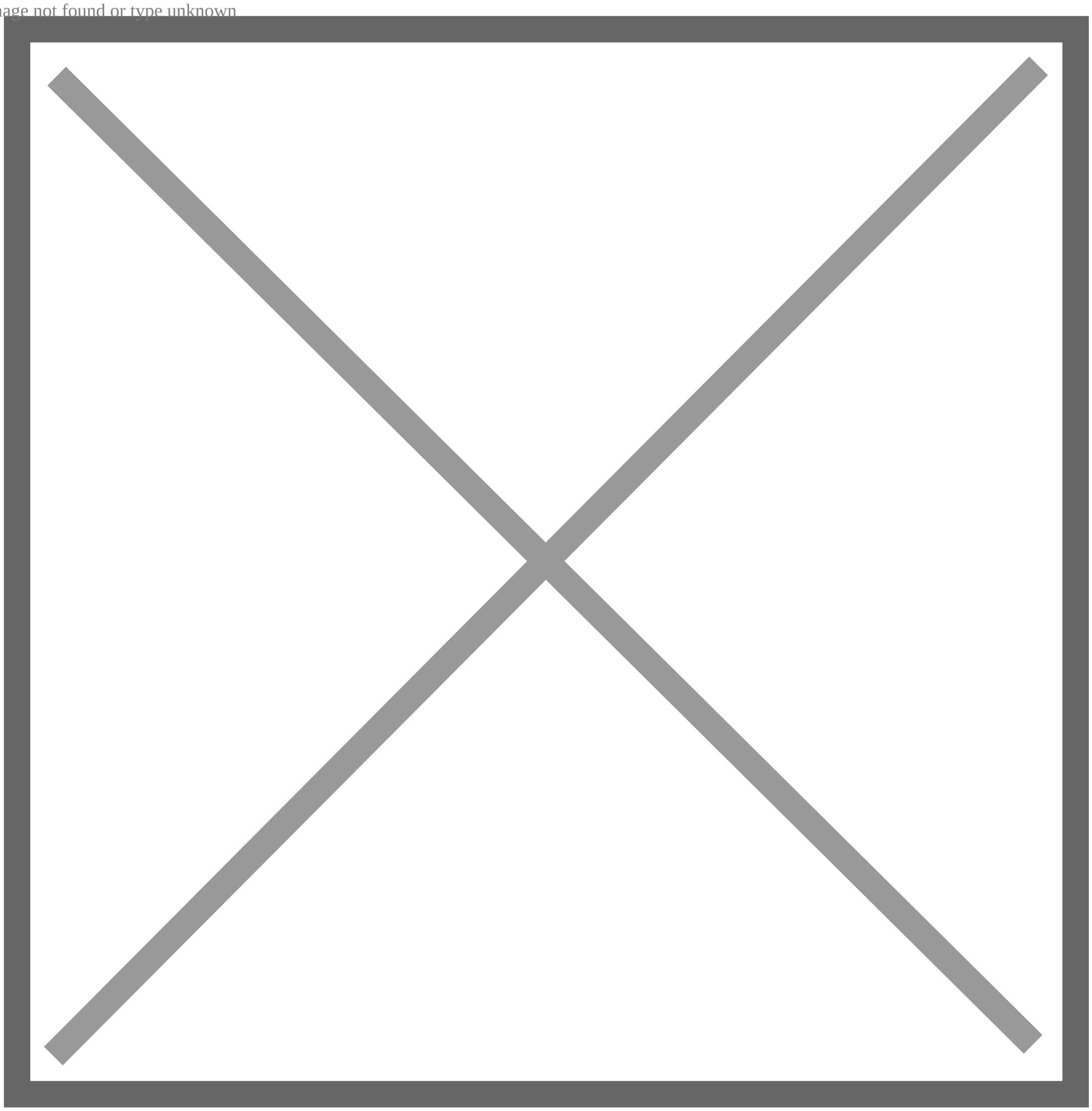
Prepaid tuition plans are cousins to savings plans—their federal tax treatment is the same, but their operation is very different. A 529 prepaid tuition plan lets you prepay tuition at participating colleges, typically in-state public colleges, at today's prices for use by the beneficiary in the future. Prepaid tuition plans are generally limited to state residents, whereas 529 savings plans are open to residents of any state. Prepaid tuition plans can be run either by states or colleges, though state-run plans are more common.

As with 529 savings plans, you'll need to fill out an application and name a beneficiary. But instead of choosing an investment portfolio, you purchase an amount of tuition credits or units, subject to plan rules and limits. Typically, the tuition credits or units are guaranteed to be worth a certain amount of college tuition in the future, no matter how much college costs may increase between now and then.

However, if your child ends up attending a college that doesn't participate in the plan, prepaid plans differ on how much money you'll get back. Also, some prepaid plans have been forced to reduce benefits after enrollment due to investment returns that have not kept pace with the plan's offered benefits.

Even with these limitations, some college investors appreciate not having to worry about college inflation each year and want to lock in college tuition prices today. The following table summarizes the main differences between 529 savings plans and 529 prepaid tuition plans:

Image not found or type unknown



Source: U.S. Securities and Exchange Commission

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, 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 by the account are taxed to your child each year under special “kiddie tax” rules that apply when a child has unearned (passive) income. Under the kiddie tax rules, a child’s unearned income over a certain threshold ($2,200 in 2020) is taxed at parent income tax rates. The kiddie tax rules generally apply to children under age 18 and full-time college students under age 24 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 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 2022, to be able to exclude all of the bond interest from federal income tax, married couples must have a modified adjusted gross income of $128,650 or less at the time the bonds are redeemed (cashed in), and individuals must have an income of $91,850 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 2022, you can contribute up to $6,000 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 percent premature distribution penalty—is spared the 10 percent 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 2022, if your filing status is single or head of household, you can contribute the full amount to a Roth IRA if your MAGI is $144,000 or less. And if you're married and filing a joint return, you can contribute the full amount if your MAGI is $214,000 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 or is assessed at 50 percent 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 into 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 does.

Source: Broadridge Investor Communication Solutions, Inc.

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948, or schedule an appointment with a retirement counselor today.