



**SAVING  
FOR  
COLLEGE**



**2022-23**

# FAMILY GUIDE TO COLLEGE SAVINGS

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[www.savingforcollege.com](http://www.savingforcollege.com)

Savingforcollege.com's Family Guide to College Savings

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Joseph Hurley is the founder of Savingforcollege.com, the leading independent source of information on Section 529 college savings plans and other ways for families to plan and save for college. For over 20 years, he worked as a certified public accountant providing tax-planning services to individuals, business and tax-exempt organizations.

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# YOUR GOAL

## Affording Your College of Choice

Most people look at the price of a college degree as an expense, like the electric or cable bill. But what if you looked at it as an investment? According to the Bureau of Labor Statistics, persons 25 or older who held a Bachelor's degree had median weekly earnings 80% higher than those with a high school diploma alone. Not only did those with a degree earn more, but the unemployment rate among those holding a Bachelor's degree was half that of those with only a high school diploma.<sup>1</sup> Still, the question remains: How will you finance that investment?

### Pay as You Go

Your child could help pay for college by getting a job, but students must already juggle studies and other college activities. Even a part-time job might distract them from their primary focus—getting an education. You can also plan to pay college expenses out of your future income as long as you realize that doing so might require substantial cutbacks in other areas of your family budget. You also want to use caution here, as the cost of college has been rising at a rate exceeding wage growth for decades.

### Pay Later

Some might suggest that you approach college tuition as you would buying a home — borrow the money to pay for college and simply repay the debt with higher earnings after graduation. Though many parents see advantages in having children contribute to their education expenses, a college education can be as costly as buying a home. Borrowing can leave a tremendous burden on a recent college grad just as they are getting started in their career. It is also far less expensive to pay for college with savings than it is to pay with debt.

### Find Someone to Help Pay

Scholarships and grants are the ideal financial aid. They don't have to be paid back. But, according to the College Board, less than \$30 billion of the \$92 billion in undergraduate federal financial aid for the 2020–21 school year came in the form of grants, while over \$40 billion was

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<sup>1</sup> U.S. Bureau of Labor Statistics, Median usual weekly earnings of full-time wage and salary workers by educational attainment, Q2 2021.

<https://www.bls.gov/charts/usual-weekly-earnings/usual-weekly-earnings-over-time-by-education.htm>

loans. (The rest was federal work-study and the value of education tax benefits.)<sup>2</sup> The states, employers, private organizations, and colleges themselves provided an additional \$70 billion in scholarships and grants in 2020-21.

Also keep in mind that the total amount of federal aid has declined annually each year since the 2010-11 school year. With less money available, students would be prudent to look elsewhere for funding.<sup>3</sup>

You also want to consider the contributions of family and friends. According to a 2014 survey released by Fidelity, 72 percent of grandparents felt that it is important to help pay for their grandchildren's college education. Consider the value of a gift made in lieu of traditional presents for your child's birthday party or special event. Many 529 savings plans offer free gifting tools to make it even easier for your friends and family to make a deposit for your beneficiary.

#### Save Now for More Freedom and More Choice Later

Saving now is the best way to ensure that you have options later.

Saving affords you the comfort of knowing that you won't be dependent on outside sources like loans or scholarships to meet college expenses. It is also much less expensive in the long run to finance college with savings than it is to do so with loans. In fact, for a newborn it would cost you \$195,891 more to borrow than to save for college.<sup>4</sup>

Many strategies and investment vehicles are available to help you maximize your college savings. Selecting a suitable strategy and the best combination of investment vehicles is critical. For each option, you face the task of evaluating key characteristics including:

- The potential for growth
- Risk of loss
- Tax implications
- Ownership and control
- Ease of management
- Fees and expenses

The decisions you make now can have a significant impact on how much money is available for

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<sup>2</sup> The College Board, Trends in Student Aid 2021.

<sup>3</sup> The College Board, Trends in Student Aid 2021.

<sup>4</sup> Based on a current annual cost of college of \$25,000, a college inflation rate of 4% and an assumed investment return in your 529 plan of 6%.

tuition payments in the future. In this guide, we focus on the most common components of a sound college savings plan — a plan that can give you and your future college student a high degree of financial security and the confidence that you can afford the college of choice.



# FEDERAL TAX INCENTIVES FOR EDUCATION

One of the best ways to increase the affordability of your child's education is to take advantage of federal tax breaks aimed at families saving and paying for college. These include the following:

**Qualified Tuition Programs (529 plans)** — Earnings grow tax-deferred and distributions are tax-free when used for qualified post-secondary education costs. As of 2018, 529 plan savings can also be withdrawn tax-free for up to \$10,000 per year in elementary and secondary school tuition expenses and, as of 2019, for up to \$10,000 in student loan repayment (lifetime limit per borrower).

**Coverdell ESAs (Education Savings Accounts)** — Earnings grow tax-deferred and distributions are tax-free when used for qualified post-secondary education costs. ESAs can also be withdrawn tax-free for a broad range of primary and secondary school expenses. See the Coverdell ESA section later in this book for details.

**U.S. Savings Bonds** — EE and I bonds purchased after 1989 by someone at least 24 years old may be redeemed tax-free when bond owners, their spouses, or dependents pay for college tuition and fees. In 2022, the tax exclusion is phased out for incomes between \$85,800 and \$100,800 (between \$145,000 and \$175,000 for married taxpayers filing jointly). These income limits increase each year.

**Individual Retirement Accounts (IRA)** — Early withdrawal penalties are waived when Roth IRAs and traditional IRAs are used to pay the qualified post-secondary education costs of yourself, your spouse, your children or your grandchildren. There are drawbacks to this, however. Taxes may still be due on the earnings portion of the withdrawals, and you may be foregoing state-specific benefits offered by alternate products. Further, while retirement assets are excluded from federal financial aid calculations, once a withdrawal is taken to pay for college, that distribution is considered in future calculations, and has a *much* higher impact on the financial aid formula.

**American Opportunity Tax Credit (AOTC)** — A parent can claim a tax credit for 100% of the first \$2,000 and 25% of the next \$2,000 of a dependent child's college tuition and related expenses (including course materials), for a maximum \$2,500 annual tax credit per child. Students can claim the credit only if they are not claimed as a dependent on another person's

tax return. The credit is phased out for incomes between \$80,000 and \$90,000 (between \$160,000 and \$180,000 for married taxpayers filing jointly). The credit is allowed only for students who are attending a degree program at least half-time and who have not completed their first four years of academic study before the beginning of the taxable year. It cannot be claimed in more than four tax years for any one student. For eligible taxpayers — anyone beyond the “kiddie tax” age — as much as 40 percent of the credit is refundable.

**Lifetime Learning Tax Credit** — A taxpayer may claim a tax credit for 20% of up to \$10,000 in combined tuition and mandatory fees for themselves, their spouse, and his or her dependent children. This equates to a \$2,000 tax credit. In 2022, the credit is phased out for incomes between \$80,000 and \$90,000 (between \$160,000 and \$180,000 for married taxpayers filing jointly). Claiming the American Opportunity Tax Credit described above means that you may not claim a Lifetime Learning Tax Credit for any of that student’s expenses in the same tax year. There is no requirement that the student be studying towards a degree or be enrolled at least half-time, and there is no limit on the number of years the credit may be taken.

**Student Loan Interest Deduction** — Up to \$2,500 in student loan interest may be deducted above-the-line as long as the debt was incurred to pay the college costs for yourself, your spouse, or your dependent, while enrolled as a student at least half-time in a degree program. For 2022, the deduction is phased out for incomes above \$70,000 (\$145,000 for married taxpayers filing jointly). A taxpayer with income above \$85,000 (\$175,000 for married taxpayers filing jointly) may not claim a deduction for student loan interest. A student who can be claimed as a dependent may not take the deduction on his or her own return.

**Tax-free Scholarships** — Most scholarships and grants are tax-free if the scholarship is used to pay for tuition and textbook expenses and the recipient does not have to provide services in exchange for the award.

**Tax-free Educational Assistance** — Employers may pay and deduct up to \$5,250 in college and graduate school costs for each employee under a Section 127 educational assistance plan. The education does not have to be job-related. The benefit is tax-free to the employee, but cannot be used to pay for an employee’s children or other family members.

These tax incentives have been updated for tax year 2022. For more information on tax incentives for education, see IRS Publication 970, *Tax Benefits for Higher Education*, available at [www.irs.gov](http://www.irs.gov).

# TOUGH CHOICES

## College Planning Versus Retirement Planning

Paying for college is not your only financial concern. Providing for your own retirement can be even more important since no one offers grants, scholarships, or federally guaranteed loans to support you when you leave the workforce.

Ideally, college and retirement should be part of the same financial plan, but you should still expect some trade-offs as you try to balance these goals. You may have to work longer than you would like or your children may have to borrow more money than they would like. The important thing is that it is possible to meet these two major financial responsibilities.

Keep these key facts in mind when thinking about retirement and college savings:

1. Most advisors agree that you should take full advantage of retirement accounts such as 401(k), IRA and 403(b) tax-sheltered annuities before funding your college savings accounts. These retirement plans offer unique tax advantages, and, in some cases, matching contributions from your employer.
2. Assets in retirement accounts will not affect your child's prospects for federal financial aid (unless you actually take distributions from them during the college years). Neither will life insurance or annuities. If your child is earning a small amount from working, a Roth IRA can be a great way to invest unspent income.
3. IRAs can even be a secondary source of college funding. Tax law permits you to tap your traditional or Roth IRA for qualified college costs without incurring the 10 percent penalty for distributions before age 59 1/2. Income tax may apply, however. Such distributions may affect eligibility for need-based financial aid.
4. Except in unusual circumstances, your 401(k) is less accessible for college. You might be able to borrow from your 401(k), but any money borrowed will have to be paid back in short order.

Just remember that using any of your retirement money to pay for education costs means it won't be there for your own retirement expenses. You probably don't want to support your children through college only to risk becoming a burden to them in your later years.

## Special Considerations for Grandparents

Surveys show that many grandparents want to help fund the college education of their grandchildren, particularly if they already have enough money to ensure a comfortable

retirement income. Grandparents in this position should investigate college savings options just as parents do, but often with different objectives in mind.

#### Typical Grandparent Goals

**Control and accessibility.** You may want to retain control of your funds and keep them easily accessible to you in case of unexpected expenses.

**Ease of management.** You probably want an investment vehicle that doesn't complicate your overall financial portfolio.

**Flexibility.** You may have several future college students to think about. They may be spread around the country and their financial situations may vary greatly depending on the financial security of their parents and their other grandparents.

**Legacy.** You want to leave a gift that helps to ensure a bright future for your grandchildren in the years to come.

**Concern about the estate planning implications of college savings choices.** Many grandparents see a dual benefit in advancing their grandchildren's education and reducing estate tax exposure.

#### Your Place in the Overall Education Savings Plan

If you decide to assist your grandchildren, it's important to involve their parents in the decision-making process. Your desire to pay college bills directly or to set up educational trusts impacts the financial aid application filed for the student.

For example, if you gift money or other property to your grandchildren under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA), any future earnings or capital gains will be reported to the child and may require the parents to prepare tax filings. UGMA and UTMA accounts are reported as a student asset on financial aid applications and have a more severe impact on eligibility for need-based financial aid than parent assets.

Be sure to consider the benefits of a 529 plan. Many grandparents find it to be a particularly attractive investment program. Like any other grandparent-owned investment, your 529 plan is not counted as an asset in the determination of financial need for federal student aid programs. However, any money actually spent on behalf of the student must be added to student income on the aid application. Student assets and income have a much greater impact on financial aid

eligibility than parent-owned assets (see Financial Aid Considerations). Alternately, you can contribute to a parent-owned 529 plan.

# COMPARING COLLEGE SAVINGS ALTERNATIVES

With so many choices available for college savings, you may be overwhelmed. Don't let that stop you from moving forward! Here are the major options, with some of their key advantages and disadvantages to help you with your planning.

## 529 PLANS

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### General Description

The technical name for 529 plans is "qualified tuition programs" and there are two basic types — the *Section 529 prepaid program* and the *Section 529 savings program*. Both types provide tax benefits, but they work in different ways. Ten states currently offer enrollment into a prepaid program, and a group of private colleges are included in a prepaid program called the Private College 529 Plan. With the exception of the state of Wyoming, every state, along with the District of Columbia, offers at least one 529 savings program. Each 529 plan has certain unique rules and investment characteristics and it's important to find one that suits your specific needs.

In a 529 prepaid program, you make a payment now or a series of payments over time, and the program promises to pay future tuition and fees for a certain number of credit hours or semesters at specified colleges or universities. Though not quite as flexible as 529 savings programs, these plans may be attractive to families seeking a hedge against future tuition increases.

State-run prepaid programs are usually geared to families that intend to send their children to in-state public institutions and may not cover college costs other than tuition and mandatory fees. However, their benefits can always be converted for use at other schools. The conversion method most commonly used is to compute the average in-state tuition and make that amount available for private and out-of-state colleges.

Because you can't be sure your beneficiary will finish college, it is important to understand how much of your "prepaid" money will be refunded if you ever cancel the contract. Some programs will pay interest on your returned payments while others will not. You may also incur cancellation fees.

Section 529 savings programs are sometimes referred to as college savings plans ("CSP") or college investment plans ("CIP"). You can open an account and make contributions for any individual beneficiary you choose (your child, grandchild, neighbor or even yourself). Contributions are invested on behalf of your beneficiary, according to the investment strategy you select. All 529 savings programs are state-sponsored and most are open to residents of any state. It generally doesn't matter where your beneficiary attends college. We discuss the 529 savings programs in more detail because they are increasingly popular and provide more choice than the 529 prepaid programs.

Beginning in 2018, 529 plan benefits have been expanded to cover up to \$10,000 of elementary and secondary tuition costs, so they are technically no longer just college savings plans, but rather a broader education savings vehicle. However, 529 plans will tend to accrue greater earnings and greater tax benefits the longer they are held. Therefore, for many families the primary savings goal of a 529 plan will continue to be college costs.

## **How a 529 Savings Program Works**

529 savings programs offer a menu of investment strategies, which typically include 1) dynamic age-based or enrollment date options that gradually shift from a concentration in equities to a concentration in less risky fixed income securities as your child approaches college age and 2) static options that maintain a constant blend of equities and fixed income securities. Often, the underlying investments in these portfolios are mutual and exchange-traded funds. Some programs also offer a principal-protected account that earns a specified level of interest.

Remember, contributions to a 529 savings program that are invested in stocks and bonds are not guaranteed to keep up with college inflation. In fact, they can lose value over any given time period.

When the time comes to withdraw money for your beneficiary's education costs, you simply direct the 529 program administrator to send a distribution from your account either to you or to your beneficiary. Most programs will even pay college bills or K-12 tuition directly upon your instruction. Distributions can be taken for any purpose; however, distributions during any year that total up to more than the qualifying college expenses incurred during that year can result

in income taxes and penalties.

## **Core Benefits of a 529 Savings Program**

**Professional investment management.** Most states have hired outside investment firms or mutual fund companies to design and manage their 529 savings programs.

**Flexibility.** You may change the beneficiary on the account to another qualifying family member at any time. In addition, your 529 account can be rolled over to a different state's 529 plan without triggering federal taxes provided no other rollover for your beneficiary has occurred within the prior twelve months.

**Generous contribution limits.** Low minimum contribution requirements and high maximum contribution limits generally let families invest as little or as much as they can afford. Federal law imposes no annual contribution limits on 529 plans and many 529 savings programs have lifetime contribution limits exceeding \$400,000 per beneficiary. Minimum contributions are typically low, usually \$25 or less, and most 529 savings programs allow systematic investments through automatic withdrawals from your bank account or deductions from your paycheck.

**Control.** You maintain ownership and control of the 529 account. You make all decisions including when to withdraw money and what to use it for. You can even take it back for yourself. Your beneficiary generally has no rights to the account no matter their age.

## **Tax Advantages of a 529 Plan**

Federal income tax

The most attractive benefit of a 529 investment or prepaid program is that all money contributed to the plan can grow tax-deferred and be withdrawn tax-free for qualified education costs. Although contributions are not deductible on your federal income tax return, the tax-deferred compounding of any earnings can be a powerful factor in eventually meeting tuition expenses.

Here's how the tax advantage works:

1. You select a 529 plan and make your contribution(s). You then receive periodic statements (annual, quarterly, or monthly) for each account you own. However, even as your account grows, there is nothing to report on your income tax return, unless you take a distribution.
2. Once distributions begin, you or your beneficiary (depending on program procedures)



will receive an IRS Form 1099-Q from the program administrator reporting any distributions during the year. This form specifies the principal and earnings portions of the distribution (computed pro-rata).

3. In preparing your or your beneficiary's income tax return, count up the qualified higher education expenses incurred during the year. If these are greater than the amount of distributions, no taxes are owed. If they are less, some portion of the earnings is taxed as ordinary income (at the recipient's rate) and is also subject to an additional 10 percent penalty tax. Principal – the amount you originally put in – is not affected.

Beginning in 2018, tax-free withdrawals can be made for up to \$10,000 of elementary and secondary tuition, as well as college costs. At the K-12 level, however, the only expense that currently qualifies for tax-free withdrawal is tuition.

Qualified higher education expenses for post-secondary education, on the other hand, include tuition, fees, books, supplies, equipment expenses required for full-time or part-time attendance at an eligible educational institution, computers and related services (such as software and internet access fees), plus the special needs expenses of special needs beneficiaries. Room and board is considered a qualified expense as long as the student is attending a degree program on at least a half-time basis. Just about any accredited college or graduate school is an eligible institution, including many vocational and professional schools, as well as more than 400 foreign institutions. Foreign schools are eligible if their students can participate in federal financial aid programs. You can look up eligible institutions here: [https://www.savingforcollege.com/eligible\\_institutions/](https://www.savingforcollege.com/eligible_institutions/).

Starting in 2019, tax-free distributions can be made for up to \$10,000 each for repaying student loans of the beneficiary and the beneficiary's siblings. Parent loans can be repaid by changing the beneficiary to the parent. The \$10,000 limit is a lifetime limit per borrower.

#### State income tax

If your state imposes an income tax, it is likely to follow the federal tax treatment of your 529 plan, whether or not you choose the plan from that state. However, you should always be certain you understand the tax rules in your own state. (If you decide to open an account in a different state, you shouldn't have to worry about paying taxes to that other state unless you or your beneficiary subsequently becomes a resident.)

Over 30 states and the District of Columbia currently offer their residents a state income tax

deduction or tax credit for contributions to their 529 plans. If your state is one of them, you should consider the value of that deduction when deciding whether or not to open an account in your state's plan. Most states place an annual limit on the amount of the deduction, although a few do not. Currently, if you live in Arizona, Arkansas, Kansas, Minnesota, Missouri, Montana or Pennsylvania, you can receive a state income tax deduction for contributions you make to 529 plans outside your home state. Visit [www.savingforcollege.com](http://www.savingforcollege.com) to look up your state's tax benefits. Remember that even if your state offers a state income tax deduction or tax credit, it's always a good idea to shop around and compare the fees, performance history, ratings, and investment options of your state's plans to others before choosing a plan.

If you plan to use your 529 plan to pay for K-12 tuition, a word of caution. If you live in a state that offers a state income tax benefit for contributions to a 529 plan, be sure you understand your state's rules. In some states, the benefit only applies when 529 plan funds are used to pay for college. States are currently reviewing the impact of the federal tax reform that expanded 529 plan benefits, to determine whether updates to state legislation are required.

At the state level, the earnings portion of non-qualified withdrawals may be subject to state income tax and, in some cases, a state income tax penalty. You may also have to repay any deductions or credits previously claimed. If you are unsure, consult with your 529 plan.

#### Estate and gift tax

Another benefit of 529 plans is their usefulness in estate planning. The value of your 529 account is not included in your gross estate. Individuals with sizable estates typically find this benefit very attractive.

However, contributions to a 529 plan are treated as a gift from you to the named beneficiary on the account. If the beneficiary is a grandchild, you may also be subject to the generation-skipping transfer ("GST") tax.

Even considering the gift tax, 529 plans are attractive. In 2022, you can use your \$16,000 (\$32,000 for a married couple) per-recipient annual gift tax exclusion to avoid gift tax and GST tax.<sup>5</sup> Any contributions larger than your available annual exclusion must be reported on a gift tax return and will consume part of your \$12.06 million (in 2022) lifetime gift exemption (\$24.12 million for a married couple).

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<sup>5</sup> Be sure to count other cash or property gifts you make to your beneficiary during the year in determining how much of this exclusion is still available for your 529 plan contributions.

You can also take advantage of a special five-year election that allows you to put as much as \$80,000 into a 529 plan for each child immediately without gift tax or GST tax. This uses up all or part of your annual exclusions for the next five years. 5-year gift-tax averaging is known as *superfunding* a 529 plan.

Gift tax issues can also occur later in the life of a 529 account. There is no gift tax consequence if you change the beneficiary of the account to another family member in the same generation, such as a sibling or cousin. However, if you change the beneficiary to another family member who is at least one generation below the former beneficiary, the former beneficiary may be required to treat the value of the account as a gift to the new beneficiary. Be sure to review any gift tax consequences before changing beneficiaries.

## **Possible Disadvantages to a 529 Plan**

**Penalties for non-qualified distributions.** If distributions exceed qualified educational expenses, you will owe ordinary income tax and a 10 percent tax penalty on earnings portion of the excess distribution. The resulting tax bill may be much higher than the taxes on an alternative investment (like an UGMA/UTMA investment account) that qualifies for capital gains treatment. The 10 percent tax penalty is waived if the excess distribution is attributable to the beneficiary's death, disability, receipt of a scholarship, or claiming the American Opportunity or Lifetime Learning credit. One way to avoid taxes and penalties when the original beneficiary doesn't need the money for school is to change the beneficiary to another qualifying family member.

**Program costs.** In addition to the cost of underlying mutual funds, most 529 plans charge a modest investment or program management fee against the value of your account. There may also be an enrollment fee, annual account maintenance fee, rollover fees and other transaction expenses. If you open an account through a financial advisor, you may incur a sales charge or additional annual expenses that compensate advisors for their services. Fees and expenses are disclosed in the program enrollment materials.

**Gift taxes.** There are ways to pay for college that do not involve gift taxes. Under most state statutes, parents can simply pay their child's college costs as part of their overall support. Similarly, grandparents or other relatives can pay tuition directly to the school without gift-tax consequences, but this may affect the student's eligibility for need-based financial aid.

**Regulations and restrictions.** Owners have little or no control over how a state operates its 529 plan. Program rules and fees can be changed at any time. The state can also change the investments (or the investment manager) under certain conditions. If you don't like the changes

being made, your only recourse is to request a non-qualified distribution or to roll over your account to another 529 plan.<sup>6</sup> That said, historically most changes that have been made provided plan participants with lower fees and higher-quality investment options. Average fees on direct-sold 529 college savings plans have dropped in half over the last decade.

**Investment changes.** You may switch among your plan's investment options whenever you change beneficiaries on the account. However, the IRS has placed a limit of two changes per calendar year if the beneficiary is not changed.

## Choosing a 529 Plan

Start by investigating the 529 plans offered by your own state and by the state where your beneficiary resides. You may discover that there are benefits for residents that are not available to you by participating in a different state's 529 plan. For example:

- Find out if your state offers a state income tax deduction or tax credit for some or all contributions to its 529 plan.
- A few states offer a partial match of contributions for low-income families or a scholarship for beneficiaries. Or they may give their residents a break on program expenses and fees.
- A state may exclude the value of your account when determining eligibility for state-funded financial aid programs.
- Creditor protection and other legal concerns may be more clearly defined with your own state's 529 plan.
- Residents of Alabama must use the in-state 529 plan in order to avoid paying state income tax on qualified distributions. Residents of other states do not face this restriction.

Once you've considered your own state's plan, take a look at what other states offer. Despite the potential advantages of a same-state investment, thousands of investors are choosing other states' 529 plans. The attraction of an out-of-state plan may include the quality of the investment options or the regulations of the program and the potential for lower fees. You may even decide to establish accounts in more than one 529 plan in order to meet all your objectives.

When choosing a 529 plan be sure to evaluate the following factors:

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<sup>6</sup> Some states treat an outbound rollover to another state's 529 plan as a non-qualified distribution, even though it is not considered a non-qualified distribution by the IRS.

**Investment Options.** Make sure your 529 plan offers at least one option that meets your investment objectives and tolerance for risk. Consider a blend of stocks, bonds, and interest-bearing accounts that offer principal protection. Some 529 plans offer mutual funds from a single fund family while others select mutual funds from a number of different fund families. Some 529 plans offer actively managed mutual funds, some offer passive index funds and some offer both. Decide which approach seems better for you. Ask about special investment features, like a program that matches your investment to your child's age, automatically shifting away from stocks and toward fixed income investments as college approaches.

You will probably want to consider the performance of the investment portfolios available through the plan; however it's not a good idea to select a 529 plan based strictly on historical investment performance. Some 529 savings programs have not been around long enough to have meaningful track records. Even if they were, it is sometimes difficult to make an "apples to apples" comparison when their investment portfolios have different stock and bond allocation targets. To get some idea of how the investments in a particular 529 plan have performed, look for the results in official program disclosures. You may also be able to research the investment performance and characteristics of the underlying mutual funds by accessing individual fund company websites.

Also, be sure that you have a clear investment objective. Are you saving for college, or for K-12? If you're saving for both, you may want to consider separate 529 plans for each objective. You will naturally have a longer time horizon when saving for college than when saving for, say, private middle school. You will be more concerned with maximizing earnings when you have more time, and minimizing losses when you have less time, so it's important that you choose investment portfolios that are appropriate for your time horizon.

You can find more in-depth information on the underlying investments of any 529 savings plan on Savingforcollege.com. Search for a plan at [www.savingforcollege.com](http://www.savingforcollege.com), then click on Investment Options on the plan results or plan details page.

**Expenses.** Be sure you understand all program fees and investment expenses as well as the impact they will have on your overall return. Some 529 savings programs will "wrap" the underlying mutual fund expenses into their program management fees while others will keep them separate.

**Professional Assistance.** Developing a financial plan for college, researching the investment options, and making appropriate decisions can take substantial time and effort. If you are comfortable doing this on your own, you may be able to reduce your costs with "direct-sold"

529 plans. On the other hand, if you want the assistance of a financial advisor, you can work with a fee-based financial planner or a commission-based broker. Advisor-sold 529 plans are sold only through financial professionals.

**Program Structure and Restrictions.** Because 529 savings plans are custom-crafted by individual states, rules and restrictions vary from plan to plan. Review the overall plan structure. Some differences are obvious, such as maximum and minimum contribution levels. Other factors may be more difficult to discern but could be even more important for 529 owners and beneficiaries:

- Will you be allowed to transfer the ownership of your account to another individual, or to a trust?
- Who ends up controlling the account if you die? Are you permitted to designate a successor owner on the application? And what happens if you don't designate one?
- How quickly will your contributions be invested after being received by the program administrator, and how long will it take for your withdrawal requests to be processed?
- If you are using a prepaid tuition plan, do you have to use the account within a specified number of years, or by the time your beneficiary reaches a specified age?
- What are the withdrawal procedures? Does the 529 plan provide you with the ability to select either the account owner, beneficiary or school as recipient in all instances?

In general, you want a 529 plan that takes advantage of all the power and flexibility permitted under federal tax law. If the plan that best suits your needs doesn't offer every feature you want, you can open accounts in more than one program or roll over your account to another plan before a restriction becomes a problem.

## **The Residency Factor**

To enroll in a 529 plan, most programs require only that you be at least 18 years old and that both you and your beneficiary have a valid Social Security Number or Individual Taxpayer Identification Number (ITIN). Although some 529 savings programs and nearly all prepaid programs require that you or your beneficiary reside or work for an employer within the sponsoring state, many 529 plans have no state residency restrictions.

Some states offer one version of their 529 savings programs to state residents, and another version to others, including nonresidents and residents who open their account through a broker or a participating employer. The two versions may have different expenses and may even offer different investment options.

For further information on all the 529 plans, visit [www.savingforcollege.com](http://www.savingforcollege.com).

## 529 ABLE ACCOUNTS

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### General Description

The ABLE Act, which was signed into law in December 2014, allows Americans who are living with disabilities to save money for college and other expenses in a tax-deferred account as a supplement to private insurance and public benefits.

Similar to a 529 college savings plan, 529 ABLE accounts are savings accounts administered by the states. Money can be withdrawn tax-free when the funds are used to pay for qualified disability expenses. Qualified disability expenses include, among other things, medical treatment, education, tutoring, job training, special needs transportation, housing, and legal and administrative fees. The contribution limit for 2022 is \$16,000 (the amount of the annual gift tax exclusion) and many states have total contribution limits that exceed \$400,000.

Only the first \$100,000 saved in the account is exempted from the \$2,000 Supplemental Security Income (SSI) limit. Beneficiaries with account values greater than \$100,000 will not receive SSI benefits, but will still receive Medicaid.

### Eligibility

To qualify for a 529 ABLE account, individuals must have been diagnosed with a significant disability before they turned 26 years old, with a condition expected to last at least 12 consecutive months. The individual must also be receiving benefits under SSI and/or SSDI, or be able to obtain a disability certification from a doctor.

Recent changes in the tax law now allow tax-free rollovers from traditional 529 savings accounts to 529 ABLE accounts, up to the amount of the annual contribution limit. Another important change allows individuals who are working and earning income to contribute an additional amount to an ABLE account, up to the current poverty level, above the \$16,000 limit. This is provided they do not participate in their employer's retirement plan.

### Availability

529 ABLE accounts are the “new kid on the block,” in investment terms. Every state has either active or passed legislation allowing them to offer these plans. As of mid-2020, 43 states have launched their plans. Some plans have residency requirements to enroll, and Oregon offers two plans: one for in-state residents and the other available nationwide. Smaller states have partnered on ABLE plans. For example, Ohio has partnered with Arizona, Georgia, Kentucky,

New Hampshire and Wyoming to offer its STABLE Account to residents of those states. Expect more plans to launch as each state evaluates its options.

## **Forfeiture Clause**

529 ABLÉ accounts have a forfeiture clause that distributes all or part of the 529 ABLÉ account to the state upon death of the beneficiary to reimburse the state for medical assistance provided to the beneficiary after the establishment of the 529 ABLÉ account. The reimbursement is reduced by the amount of any premiums paid under a Medicaid Buy-In program and any outstanding payments due for qualified disability expenses. Account owners can minimize the risk of forfeiture by transferring money from a 529 savings account to the 529 ABLÉ account one year at a time.

You can find additional information about 529 ABLÉ accounts at:

[www.savingforcollege.com/529-able-accounts](http://www.savingforcollege.com/529-able-accounts)

## **COVERDELL EDUCATION SAVINGS ACCOUNT**

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### **General Description**

A Coverdell education savings account (sometimes known as a "Coverdell account", "ESA", or "CESA") lets parents, grandparents, other family members, friends or even the child contribute money to a tax-advantaged account for future education expenses. Individuals making contributions to Coverdell ESAs must meet certain income requirements described below.

To open an ESA, you may contact an investment broker or any financial institution that offers the type of investment (stocks, bonds, mutual funds, certificates of deposit, etc.) you wish to hold in the account.

You can find a list of providers at [www.savingforcollege.com/coverdell\\_esa\\_providers](http://www.savingforcollege.com/coverdell_esa_providers).

You will sign an agreement that names a beneficiary and a "responsible individual" and indicates whether the beneficiary assumes control upon reaching age 18 or the control stays with the responsible individual. Most ESA agreements require that the responsible individual be the beneficiary's parent or guardian. This can make the ESA less attractive for grandparents or other relatives.



The beneficiary of the ESA must be under 18 years old when each contribution is made. Beneficiaries with “special needs” may be older than 18.

Combined contributions on behalf of any one child may not exceed the annual aggregate contribution limit of \$2,000. Contributions in excess of limit incur a federal excise tax. You have until April 15 of next year to make this year’s contribution.

The contributor must have income less than \$95,000 (\$190,000 if married and filing a joint tax return) in order to make the maximum \$2,000 contribution. A partial contribution is allowed for incomes up to \$110,000 (\$220,000 joint). If your income is too high, another adult or even your child may make the contribution with their own money.

## **Tax Advantages of a Coverdell ESA**

Like a 529 plan, earnings in an ESA are tax-deferred and can be withdrawn free of federal taxes in a year during which the beneficiary incurs qualified education expenses.

## **Core Benefits of a Coverdell ESA**

For some families, an ESA may make more sense than a 529 plan for the first dollars being committed to college savings each year. Here are the reasons why:

**Wide range of available investments.** An ESA can include most types of investments, including stocks, bonds, fixed-rate accounts and all types of mutual funds. Since most financial institutions offer ESAs you can choose any investment or mix of investments that suits your situation. You can change investments within the account as often as you desire. You can also roll over some or all of your account to another ESA as often as once every twelve months.

**Broad definition of education expenses.** An ESA can be withdrawn tax-free to pay for a broad range of elementary and secondary school costs as well as certain college expenses. Private school tuition and many other costs at both private and public schools for grades K – 12 are eligible, including transportation, uniforms and supplies. You can even withdraw money tax-free from an ESA to pay for a home computer, software, peripheral equipment and Internet access while the beneficiary is enrolled in elementary or secondary school. 529 plans, on the other hand, may only be used for tuition expense for grades K-12, though they can be used to pay for a broad range of qualified higher education expenses for college.

**Simplicity.** Because the ESA was created by the federal government, it is a simpler and more uniform investment vehicle than the state-sponsored 529 plans. Like the IRA, every provider of ESAs follows the same basic model, making the actual investment options the primary factor in

your selection.

### **Possible disadvantages to a Coverdell ESA**

- Given the relatively low \$2,000 annual contribution limit, maintenance fees as a percentage of your account may be higher than on vehicles that permit larger investments.
- When the beneficiary reaches age 30, the account must terminate. Any remaining assets are paid to the beneficiary subject to income tax and a 10 percent penalty on the earnings. You can set up the ESA so that you have the right to change the beneficiary to another family member who is under the age of 30. Special-needs beneficiaries are exempted from this requirement.
- While the responsible individual listed on the account may direct the investment of ESA funds and maintain control over the timing and use of withdrawals, the money set aside in an ESA must be for the exclusive benefit of the named beneficiary. In this aspect, it is similar to a UGMA or UTMA account, except that you may be able to keep any excess funds out of the beneficiary's hands until age 30.
- Contributions to an ESA are potentially subject to gift tax just like a 529 plan.

## **UGMA AND UTMA ACCOUNTS**

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### **General Description**

UGMA and UTMA accounts are investments owned by your child. Because minors are not permitted by law to handle investments directly, the account is placed under the control of a custodian (in most cases the parent) subject to the state's Uniform Gifts to Minors Act ("UGMA") or the more recently adopted Uniform Transfers to Minors Act ("UTMA"). These accounts are also called custodial accounts. A custodial account is easy to establish at any financial institution and can hold most types of financial assets including stocks, bonds, fixed-rate investments and mutual funds.

Often, UGMA and UTMA accounts are used to invest money given to a child from grandparents or other relatives and family friends. Grandparents may make these gifts to reduce estate taxes, although the gift tax and generation-skipping transfer tax must be considered. (For large amounts a formal trust may be preferable to UGMA and UTMA accounts.)

### **Tax Advantages of UGMA and UTMA Accounts**

UGMA and UTMA accounts offer parents the opportunity to reduce income taxes by shifting investment income from a higher income tax bracket to a child's lower bracket. This would produce higher after-tax returns, providing more money for college. This strategy works best with older children. Before the year in which the child turns 18, only \$2,300 (in 2022) in annual investment income is taxed at the child's rate; investment earnings above that amount are taxed at the parents' marginal income tax rate. This is the so-called "kiddie tax."

Beginning in 2008, the kiddie tax was expanded to include 18-year olds as well as to include full-time college students ages 19 through 23 who do not provide over one-half of their support through their own wage and self-employment earnings. This change undoubtedly places an added financial burden on many families at the time they need the money most — to pay college bills.

### **Possible Disadvantages to UGMA and UTMA Accounts**

- **Loss of control to child.** The biggest deterrent to keeping large amounts in an UGMA or UTMA account is probably the prospect of your child obtaining direct ownership and control of any unspent funds at a certain age (either 18 or 21, depending on state law). Even before reaching this magic age your child may view the account as a future party fund rather than a college fund. A small account may not be a concern because you can probably spend the account on education or in other ways that benefit your child before he or she takes direct control.
- **Added tax paperwork.** IRS Form 1040 must be filed for any year in which a dependent child's investment income exceeds the standard deduction (\$1,150 in 2022). Preparing a child's income tax return and paying quarterly estimated taxes can be an added headache for parents.
- **Impact on financial aid.** Student-owned investments including UGMA and UTMA accounts are counted heavily in the determination of financial need. The income tax savings of shifting income to the lower tax bracket can backfire if the money reduces the financial aid package. For more information, see the discussion in "Financial Aid Considerations" on page 32.

## **TAXABLE INVESTMENT ACCOUNTS**

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### **General Description**

Education savings can be invested in a regular taxable mutual fund or brokerage account. This provides a wide range of investment options and the ability to design an investment portfolio that suits your specific needs.

#### Income Taxes

Maintaining a taxable investment account (in your name or the child's) may not work as well as tax-free 529 plans or ESAs, especially if you invest in income-generating assets such as bonds and bank certificates of deposit (CDs), or if your stock portfolio generates significant annual dividends or capital gains. Consider keeping the more income-oriented portion of your investments in 529 plans and ESAs even if you plan to hold equities in your taxable investment account.

One advantage a taxable investment account has over a 529 or ESA is that you may pay lower capital gains tax rates, even if you do not use the money for "qualified" purposes. Remember, earnings in a 529 or ESA that are distributed for purposes other than qualified education expenses are subject to tax at ordinary income rates plus a 10 percent penalty rate.

#### Gift Taxes

Federal gift taxes are another issue to consider when holding appreciated stocks or mutual funds in a taxable account and then transferring them into a child's UGMA or UTMA account just before college. If you transfer property to your child, even if it is later used for college expenses, the value of the property that does not fall within your \$16,000 (in 2022) annual gift tax exclusion will have to be reported as a taxable gift on a federal gift tax form. The alternative is to liquidate your stocks or mutual funds and pay the college expenses yourself, without gift tax consequences in most situations. Grandparents may be especially interested in the unlimited gift tax exclusion for direct payment of tuition to an educational institution. But the capital gains from selling your investments will now be reported on your own tax return.

# TRANSFERRING ASSETS BETWEEN ACCOUNTS

Many families may already have money in one type of college savings vehicle and now want to move it to another type. This is certainly possible, but it is important to look at all aspects of the transfer, including ownership considerations, income tax implications and gift tax consequences. Here we review some of the most common transfers.

## **UGMA and UTMA Accounts to a 529 Plan**

The income tax advantages and investment approaches offered in a 529 plan may make them a more attractive choice for your child's UGMA or UTMA account money. Most 529 plans accept money from UGMAs and UTMAs, either by permitting the custodian to establish the account, or by providing a checkbox on the 529 application to indicate that an UGMA or UTMA account is the source of contributed funds. A few 529 plans are more vague and leave it to you (and your legal, tax, and financial advisor) to figure out how the transfer can be accomplished under state law.

In any event, if the money in a 529 account came from an UGMA or UTMA account:

- When the child reaches the age of 18 or 21 (depending on the particular state law), the custodianship terminates and the child becomes the direct owner of the 529 account
- The beneficiary of the account can no longer be changed
- Any distributions must be for the benefit of the child

It's important to put non-UGMA/UTMA money into a separate 529 plan account so that you can retain control and ownership. You can open two accounts in a single state when one account is designated as a custodial 529 plan account. In fact, rather than transferring the UGMA or UTMA money to a 529 plan, you may even want to use that money for discretionary expenditures before the child reaches the age of majority — for example summer camp expenses — and replace it with new money put into your self-owned 529 account.

Lastly, 529 plans can only accept cash, so a transfer of appreciated securities from an UGMA or UTMA account requires liquidation of those securities, possibly triggering capital gains.

## **UGMA and UTMA Accounts to a Coverdell ESA**

Transferring money from an UGMA or UTMA account to a Coverdell education savings account (ESA) appears straightforward — both types of account are held by a custodian for the benefit of the child. However, such a transfer may prevent any future beneficiary changes and may require turning over control of the ESA to the child at the age of 18. You should seek legal guidance if you have concerns about this. Like 529 plans, ESAs only accept cash so the liquidation of appreciated securities in order to transfer money from an UGMA or UTMA account can create a tax liability.

## **Coverdell ESA to 529 Plan**

If your child has a Coverdell ESA, money from that account can be transferred to a 529 account without triggering a tax liability, as long as the child remains the beneficiary of the 529 account. This could be an effective strategy if your child is about to turn age 30 with unspent funds in a Coverdell ESA.

This does not work in reverse; transfers from a 529 account to a Coverdell ESA are treated as distributions subject to tax and penalty.

In any tax-free transfer from a Coverdell ESA to a 529 account, the untaxed earnings in the Coverdell ESA must be reported to the 529 plan so that a “basis” adjustment can be made. This ensures that those earnings are reported as taxable income in the event that any future distributions from the 529 plan are non-qualified distributions.

There are no clear regulations regarding the ownership rights in a 529 account that receives money from a Coverdell ESA. However, similar to the UGMA and UTMA accounts, certain restrictions may be necessary to preserve the legal rights of the Coverdell ESA beneficiary.

## **529 PLAN TO 529 PLAN**

You can transfer all or a portion of one 529 account to another 529 account by using a rollover. Rollovers cannot be performed more than once in a 12-month period if you wish to keep the same beneficiary on the new account. Rollovers to an account with a different family member as beneficiary can be performed as often as you want.

There are two ways to roll over funds between 529 plans. The first is to make a contribution to a new 529 plan within 60 days after withdrawing funds from your current 529 account. The second is to request a direct “trustee-to-trustee” transfer. Either way, the tax basis of the rolled over funds must be reported to your new 529 plan so that the untaxed earnings remain accounted for. Be sure to consider other effects of a rollover, including transaction fees, gift taxes and the possible recapture of state income tax deductions claimed on the original contributions.

## **Coverdell ESA to Coverdell ESA**

You may roll over money that is withdrawn from a Coverdell ESA into another Coverdell ESA for the same beneficiary or for a member of the beneficiary’s family who is under age 30. The money must be deposited into the new account within 60 days of the withdrawal and can be done only once in a 12-month period. The law is not clear on whether a direct “trustee-to-trustee” transfer of ESA funds is subject to the 12-month requirement so check with your tax advisor first.

## **U.S. Savings Bonds to a 529 Plan or Coverdell ESA**

Qualified Series EE bonds or I Bonds may be redeemed free of tax if the redemption proceeds are placed into a 529 plan account that names yourself, your spouse or your child as beneficiary. If the 529 plan account names your child, you must be able to claim that child as a dependent on your income tax return. Therefore, grandparents owning qualified savings bonds generally can’t make this tax-free transfer. However, grandparents may be able to name themselves as the beneficiary on the 529 plan and change the beneficiary after the savings bond proceeds are contributed to the 529 plan account.

Savings bond proceeds can also be transferred tax-free to a Coverdell ESA for your dependent child. However, the low per-child annual cap on ESA contributions limits the usefulness of this technique.

To be “qualified,” savings bonds must have been issued after 1989 and you must have been at least 24 years old at the date of issuance. In order to receive the full tax exclusion, your income must also be less than \$85,800 in 2022 (\$128,650 for married taxpayers filing jointly). These income limits increase each year.

If you are satisfied with your investment in U.S. Savings Bonds, you might want to wait to redeem the bonds in a year when you, your spouse, or your dependent child is in college. As long as tuition and fees are equal to or greater than the redemption proceeds of your qualified savings bonds and your income is below the phase-out levels in that year, your redemption proceeds will be tax-free.

It may be wise to convert the qualified savings bonds to a 529 savings plan or Coverdell education savings account if your income currently falls below the income limits for tax-free redemption, but you expect it to exceed that threshold during the future college years. This way you lock in the tax benefit on the accrued bond interest.

### **IRA or 401(k) to 529 Plan or Coverdell ESA**

You cannot transfer money from an IRA, Roth IRA or 401(k) into a 529 account or ESA. Any such transfer would be treated as a distribution from the qualified retirement plan account subject to all the usual tax rules (including possible penalties).

### **529 Plan to ABLE Plan**

Beginning in 2018, qualified individuals can rollover up to \$16,000 in 529 plan funds to an ABLE account without tax consequences. However, this benefit was created by the Tax Cuts and Jobs Act of 2017, and not all states have conformed to the federal law. Check your state’s ABLE rules or consult with a tax advisor before doing a rollover.



# FINANCIAL AID CONSIDERATIONS

More than 83% of all college undergraduates received some type of financial aid during the 2017-2018 school year, so it makes sense to explore this avenue for your own child.<sup>7</sup> Most financial aid is provided by the federal and state governments. Colleges, scholarship organizations and employers are also important aid sources.

Financial aid is primarily composed of “self-help” — interest-subsidized loans and work-study — and “gift aid” consisting of grants and scholarships. Gift aid is more attractive, of course, because it doesn’t have to be paid back and doesn’t place additional demands on the child.

The amount and type of financial aid offered is based on two factors: the student’s financial need and the student’s merit (scholastic, athletic, musical, artistic, etc.). Here, we focus on financial need since that is the factor most impacted by your investment decisions.

Three basic ingredients determine how much need-based aid your child is eligible for.

- **The “expected family contribution” or “EFC.”** This is the amount your family will be expected to pay for college based on your particular financial circumstances. This figure is determined by the federal government with data you provide on the Free Application for Federal Student Aid (FAFSA). The calculation considers the student’s income and assets and the parent’s income and assets. (For independent students, parental income and assets are excluded.) The parents’ contribution is divided by the number of children attending college at least half-time.
- **The cost of the school your child is considering or already attending.** Every school calculates its “cost of attendance” or “COA” based on federal guidelines. As you might expect, many private colleges have a high COA while public universities and colleges have a relatively low COA for state residents.
- **The dollar amount of “resources” provided to the student from outside sources.** Scholarships, for example, are considered a resource. So are payments of tuition directly to the college by a grandparent or employer. A resource will reduce the COA, and therefore the need-based aid award, on a dollar-for-dollar basis.

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<sup>7</sup> National Center for Education Statistics, Sources of Financial Aid, Table 331.20 (Digest 2019)

Assume, for example, that your child is planning to attend a private college costing \$25,000 per year. Your expected family contribution is \$15,000, consisting of the student's contribution of \$2,000 and your contribution of \$13,000. A local civic organization has awarded your child a \$1,000 scholarship. Your child's financial need is determined to be \$9,000 computed as follows:

(1) Cost of attendance		\$25,000
(2) Expected family contribution		
Student's contribution	\$2,000	
Parents' contribution	\$13,000	
Total family contribution		- \$15,000
(3) Resources		- \$1,000
<b>Financial Need = (1) – (2) – (3)</b>		<b><u>\$9,000</u></b>

The school will attempt to put together a financial aid package that covers the \$9,000 in financial need. This package can be a combination of grants, work-study and loans from federal, state, college and private sources. Many colleges leave students with a gap of unmet need.

It is important also to complete the FAFSA and apply for aid as soon as allowed, as some schools distribute aid on a first-come, first-served basis. Previously you had to wait until January 1 of the upcoming school year to file a FAFSA, but now you can file a FAFSA form as early as October 1 of the previous year. For example, you can file the 2022–23 FAFSA starting October 1, 2021, using income information as reported on your 2020 income tax return.<sup>8</sup>

## Financial Aid and Your Savings

In order to determine the investment mix that offers the most favorable impact on your child's federal financial aid eligibility, let's first look at how the formula for computing EFC works. The formula counts the following financial resources as being available to pay college expenses:

- 20% of a student's assets (money, investments, business interests and real estate)
- Up to 50% of a student's income (after certain allowances)
- 2.64% – 5.64% of a parent's assets (money, investments, certain business interests and real estate, based on a sliding income scale and after certain allowances)

<sup>8</sup> U.S. Department of Education, Filling Out the FAFSA Form, <https://studentaid.gov/apply-for-aid/fafsa/filling-out>

- 22% – 47% of a parent’s income (based on a sliding income scale and after certain allowances)

Now let’s see how specific types of assets affect the aid formula:

- A favorable asset to own when applying for financial aid is a retirement plan account such as an IRA or 401(k). These qualified retirement plan accounts, whether owned by you or by your child, are not counted at all as assets in determining EFC for purposes of federal financial aid. Be careful, however, about taking money out of your IRA (or any retirement account) to pay for college. Though the tax law now permits penalty-free withdrawals from a traditional or Roth IRA to pay for qualified college costs and a tax-free return of contributions from a Roth IRA, doing so could jeopardize financial aid in a subsequent year. The entire withdrawal, principal and earnings, counts as income on the financial aid application form.
- The equity in your primary home, a small family-owned business, insurance policies and annuities are also excluded from your assets when determining the EFC.
- Assets that belong to the student result in a greater reduction in financial aid. UGMA and UTMA accounts are counted as the student’s assets. In addition, they may increase the student’s included income to the extent that interest, dividends and capital gains are reported on the student’s income tax return. Often, the income tax benefit of setting aside investment assets in a child’s name is more or less offset by the reduction in the child’s financial aid package.
- 529 plans and Coverdell ESAs may be two of the better options to save for college without jeopardizing financial aid. Congress has bestowed these investments with special advantages for aid-eligibility purposes.
- If a parent owns the 529 account or Coverdell ESA, up to 5.64% of the value is included in the EFC as a parent asset. If grandparents own the account, none of the value is included.
- A 529 plan account or Coverdell ESA owned by a dependent student, or by a custodian for the student, does not have to be included with other student-owned investments. These accounts are reported on the FAFSA as parent assets.
- Withdrawals from 529 plans and Coverdell ESAs are also treated advantageously, if the account is owned by the student or parent. Such withdrawals when used for college are

excluded from your federal income tax return, and except for withdrawals from a 529 plan owned by a grandparent or other third party are not required to be “added back” when reporting income on the FAFSA. Qualified distributions from a 529 plan or Coverdell ESA that is owned by a grandparent or other third party are reported as untaxed income to the student on the FAFSA.

One workaround for grandparents who want to help pay for college is to wait until January 1 of the student’s sophomore year of college to take a 529 plan distribution. Income from two years prior is reported on the FAFSA. If the student plans to graduate in four years, there will be no subsequent year’s FAFSA to report the income. Grandparents could also rollover the 529 plan money to a parent-owned 529 plan. The parent-owned 529 plan should be in the same state as the grandparent-owned 529 plan to avoid state income tax on the rollover and recapture of state income tax breaks attributable to the rollover.

In December 2020 the FAFSA Simplification Act was passed, which would enable grandparents to use 529 plan funds for their grandchildren without impacting financial aid eligibility. However, in June 2021 the Department of Education announced that these changes would not be fully implemented until the 2024-25 school year.

Note that some colleges will calculate financial need using a different formula when offering their own grants and tuition discounts. The “institutional methodology” used by many of these colleges may count home equity, siblings’ assets, small family businesses, retirement plan accounts and certain investment accounts in a manner that differs from the federal methodology.

To help simplify the aforementioned, remember these four basic points:

1. No matter what the rules say, college financial aid administrators have great latitude in determining the financial aid package your child ultimately receives. Financial aid administrators sometimes use “professional judgment” to adjust the figures — increasing the amount of aid or creating a more attractive ratio between gift aid and self-help aid. They might be more apt to do so if they see other reasons to want your child, such as special abilities or unique characteristics.
2. The rules are constantly changing. The way the financial aid system works today may not be the way it works when your child is ready for college.

3. Your investment decisions now do not necessarily lock you in for purposes of future financial aid eligibility. You will likely have many additional opportunities to enhance your child's prospects for financial aid.
4. Saving for college reduces your reliance on an uncertain financial aid system. Some families make the mistake of spending because they believe that saving puts them in a worse position to receive financial aid. Planning and saving for college helps you control your family's destiny no matter what the future brings.

# OTHER LEGAL ISSUES

You may have additional questions about the impact of college savings on your overall financial situation. For example, what happens to your college savings account if you die? What happens if you are sued or file bankruptcy? Will it affect your application for Medicaid assistance if you enter a nursing home?

An attorney experienced in these matters is the best person to guide you as you consider the possibility of future events that might derail your best-laid plans for college. The laws of your own state, along with the state of any other party seeking an interest in your property, will usually control the outcome when there is a dispute or action.

## 529 Plans

Created in 1996, 529 plans are still new relative to other investment and savings vehicles (by comparison, the first U.S. Savings Bonds were first issued back in 1935 and 401(k) retirement plans became available in 1980). Relatively, 529 plans are somewhat untested in the areas described above. The fact that the account owner generally has unrestricted access to the funds in a 529 plan account may make it more vulnerable to creditors than money in a qualified retirement plan, IRA or well-drafted trust. It also may mean that state Medicaid agencies are likely to consider 529 accounts as a source of payment for medical and nursing home bills before Medicaid assistance is made available.

Several states provide their 529 plans with statutory protection from creditor's claims. How this protection extends to plan participants in other states remains uncertain. In 2005, 529 accounts under certain conditions gained added protections under the federal bankruptcy law.

## Coverdell Education Savings Accounts

A Coverdell ESA is generally less accessible to creditors. These accounts are established for the benefit of the child and do not provide you or other contributors with rights of ownership. Many states have extended their protections for qualified retirement plans and IRAs to Coverdell ESAs as well, and the 2005 bankruptcy protection changes also apply to Coverdell ESAs.

## Protecting College Savings through an Irrevocable Trust

Irrevocable trusts are another option for the protection-minded investor. Your attorney can help you establish and fund a trust with spendthrift provisions to ensure use of the assets for the purposes you deem important. Trusts can be expensive to set up and maintain, however, so

you would need to have sufficient assets to justify that cost. You will also need to plan for the payment of income tax on earnings generated by taxable investments held in the trust. The income tax bracket for a trust that does not distribute all its income each year becomes very high very quickly. Trusts can also impact aid eligibility.

# PUTTING YOUR PLAN TOGETHER

There are too many pieces in the college savings puzzle for there to be a single solution that fits every family. Your particular circumstances determine what’s best for you. That said, there is some general advice that will help you make a plan.

Establish a savings budget. One of the first steps you should take in planning for your child’s future college expenses is to establish a savings goal. There are many free college cost calculators available, including those from Savingforcollege.com, and we encourage you to utilize them. But, you can also get a rough idea of how much you should be saving every month just by referring to the chart below. It shows the monthly savings goal from now through college graduation for a family with one child expected to enroll in the average four-year public university or the average four-year private college.

You can use the World’s Simplest College Calculator to determine how much you need to save each month to meet your goal. Go to [www.savingforcollege.com/calculators/college-savings-calculator](http://www.savingforcollege.com/calculators/college-savings-calculator).

Monthly Savings Required to Fully Fund College Through Final Month of Attendance*			
Type of School		Public	Private
Current annual costs**		\$22,180	\$50,770
Child’s Age	Newborn	\$413	\$945
	Four	\$502	\$1,150
	Eight	\$645	\$1,474
	Twelve	\$907	\$2,079
	Sixteen	\$1,588	\$3,635

\* Assumes 4% annual college cost increase and 6% annual investment return.

\*\* Current annual costs are based on The College Board, *Trends in College Pricing 2020*.



**Make saving automatic.** It is easy to save if the process is automatic, so you don't have to remember to contribute to your college savings plan. Most 529 plans offer automatic investment options which transfer contributions from your bank account every month. Some 529 plans offer payroll deduction from select employers. There are also college savings reward credit cards where rebates based on your purchases are automatically swept into a linked 529 plan.

**Minimize taxes.** Take advantage of the fact that your child can receive up to \$1,150 in investment income without paying federal income tax (and at low income tax rates above that amount as long as the kiddie tax doesn't apply). By gifting income-generating assets into a UTMA account now, or gifting appreciated assets later, you can effectively shift income and capital gains out of your higher tax bracket. The opportunities for tax savings may be even better if you can employ your child in the family business. Remember that any assets gifted to your children are theirs to control when they reach a certain age under state law, and that a student's assets and income are counted more heavily under financial aid formulas. Be sure to speak with your tax advisor before making any tax-related decisions.

**Consider 529 savings plans and Coverdell ESA accounts even for older children.** Just because your child is already in high school doesn't mean you can't benefit from tax-advantaged college savings plans. If your most recent IRS Form 1040 shows income tax on interest, dividends or capital gains distributions, you have the chance to save taxes with a 529 plan or Coverdell ESA even if only for a few years. Every dollar you save is a dollar less you'll have to borrow. If your state offers a state income tax deduction or tax credit for contributions to its 529 plan, you might even benefit by opening an account and soon thereafter start taking distributions to pay college bills.

**Invest tax-free whenever possible.** If your child will be attending a private or religious elementary or secondary school, consider opening a Coverdell ESA. If your child still has money in the Coverdell ESA after high school it can then be used tax-free for college. In addition, keep in mind that 529 plans can now also be used to pay for up to \$10,000 per year of tuition expenses in grades K-12 and repay up to \$10,000 in student loans. However, be sure you understand any state tax implications before you use 529 funds for this purpose.

**Create the right asset mix between your taxable and tax-free investments.** If you maintain a fully taxable investment portfolio and a 529 plan or Coverdell ESA, consider concentrating the growth portion of your investments in the taxable accounts and the income-producing portion in your 529 plan account or Coverdell ESA. Growth stocks and low-turnover equity mutual funds

are already tax-efficient and can take advantage of low capital gains tax rates, while income-producing investments are less tax-efficient and can benefit from the tax shelter of a 529 plan or Coverdell ESA. Capital losses in a taxable investment can also provide a tax benefit, while a 529 plan or Coverdell ESA cannot produce a capital loss.<sup>9</sup>

**Put the right person in control.** Grandparents using a 529 plan to save for a grandchild's college education should open the account in their names if they want to maintain control and retain the ability to change the beneficiary to another grandchild. However, if the grandparents prefer that the parent control the account, they can simply make a contribution into the parents' 529 account. Just be sure to look up any potential state tax benefits from contributions. Some states allow anyone to claim a tax deduction or credit for contributions, but in others it must be the account owner.

Another easy way to "gift" a 529 plan contribution into an account for a grandchild is to make the check out in the name of the 529 plan and hand the check to the parent who can make sure it is contributed on behalf of the grandchild. For gift tax purposes, the grandparent is still the one making the contribution and can make the five-year election discussed previously in this guide.

**Invite friends and family to help.** Spread the message that you have opened a 529 college savings account for your child and that you would prefer that birthday, holiday and graduation gifts be directed into your account rather than be spent on a store-bought items. These contributions can add up to a considerable amount over time. Check with your 529 plan provider, as some offer online tools to make contributions from friends and family even easier.

**Consider professional assistance.** We suggest you consult with experienced and knowledgeable financial, tax and/or legal advisors about all the matters discussed in this book. The issues are complex. If you are working with an advisor, ask which particular 529 plans they offer and what makes one 529 plan better than another. In interviewing prospective advisors you might even ask whether they have opened their own 529 accounts. It helps to know that the professional you are relying on has personal experience with 529 plans. Consider the trade-offs with lower fees and no sales charges in a direct-sold 529 plan.

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<sup>9</sup> A taxpayer liquidating a 529 account at a loss may be able to claim a miscellaneous itemized deduction. The deduction will only provide a tax benefit if the taxpayer itemizes deductions, has total miscellaneous itemized deductions in excess of 2%-of-adjusted gross income, and is not subject to the alternative minimum tax. However, the Tax Cuts and Jobs Act of 2017 eliminated miscellaneous itemized deductions for tax years from 2018 through 2025.

**Be flexible with your college planning.** Programs and investments will continue to evolve. Tax laws will change and so will your own circumstances. Review your financial situation periodically and make adjustments whenever it seems appropriate.

YEAR 2022 RULES	FEDERAL INCOME TAX	FEDERAL GIFT TAX TREATMENT	FEDERAL ESTATE TAX TREATMENT	MAXIMUM INVESTMENT	QUALIFIED EXPENSES
<b>529Plan</b>	Non-deductible contributions; withdrawn earnings excluded from income to extent of qualified higher education expenses	Contributions treated as completed gifts; apply \$16,000 annual exclusion per recipient, or up to 80,000 with 5-year election	Value removed from donor's gross estate; partial inclusion for death during the 5-year election period	Established by the program; many in excess of \$400,000 per beneficiary	College tuition, fees, books, computers and related equipment, supplies, special needs; room and board for minimum half-time students. Up to \$10,000 in tuition expenses for K-12 schools. Up to \$10,000 in student loan repayment.
<b>Coverdell Education Savings Accounts</b>	Non-deductible contributions; withdrawn earnings excluded from income to extent of qualified higher education expenses and qualified K-12 expenses also excluded	Contributions treated as completed gifts; apply \$16,000 annual exclusion	Value removed from donor's gross estate	\$2,000 per beneficiary per year combined from all sources	Tuition, fees, books, supplies, equipment, special needs; room & board for min. half-time students; additional types of K-12 expenses
<b>Qualifying U.S. Savings Bonds</b>	Tax-deferred for federal; tax-free for state; certain post-1989 Series EE and I bonds may be redeemed federal tax-free for qualified higher education expenses	No gift as qualifying bonds must be owned by the parent	Value included in bond owner's gross estate	\$10,000 face value per year, per owner, per type of bond	Tuition and fees
<b>Roth IRA</b>	Non-deductible contributions; withdrawn earnings excluded from income after age 59 1/2 – and five years; 10% penalty on early withdrawals waived if used for qualified higher education expenses	No gift involved	Value included in the owner's gross estate	\$6,000 (\$7,000 for taxpayers age 50 and over)	Same as 529 plan
<b>Traditional IRA</b>	Deductible or non-deductible contributions; withdrawals in excess of basis subject to tax; 10% penalty on early withdrawals waived if used for qualified higher education expenses	No gift involved	Value included in the owner's gross estate	\$6,000 (\$7,000 for taxpayers age 50 and over)	Same as 529 plan
<b>UGMA or UTMA</b>	Earnings and gains taxed to minor; first \$1,150 of unearned income is tax exempt; unearned income over \$2,300 for certain children under age 24 is taxed at the parent's rate.	Transfers treated as completed gift; apply \$16,000 annual gift exclusion	Value removed from donor's gross estate unless donor remains as custodian	No limit	No restrictions
<b>Mutual Funds</b>	Earnings and gains taxed in year realized; special lower tax rates for certain dividends and capital gains	No gift involved; direct payments of tuition not considered gifts	Value included in the owner's gross estate	No limit	No restrictions

YEAR 2022 RULES	ABLE TO CHANGE BENEFICIARY	TIME / AGE RESTRICTIONS	INCOME RESTRICTIONS	FEDERAL FINANCIAL AID	INVESTMENTS	USE FOR NON-QUALIFYING EXPENSES
<b>529 Plan</b>	Yes, to another member of the beneficiary's family	None unless imposed by the program	None	Counted as asset of parent if owner is parent or dependent student	Menu of investment strategies as developed by the program	Withdrawn earnings subject to federal tax and 10% penalty
<b>Coverdell Education Savings Accounts</b>	Yes, to another member of the beneficiary's family	Contributions before beneficiary reaches age 18; use account by age 30	Contributions phase out for incomes between \$190,000 and \$220,000 (joint filers) or \$95,000 and \$110,000 (single filers). No annual inflation adjustment	Counted as asset of parent if owner is parent or dependent student	Broad range of securities and certain other investments	Withdrawn earnings subject to federal tax and 10% penalty
<b>Qualifying U.S. Savings Bonds</b>	Not applicable	Bond purchaser must be at least 24 years old at time of bond issuance	Interest exclusion phases out for incomes between \$128,650 and \$158,650 (joint filers) or \$85,800 and \$100,800 (single filers)	Counted as asset of bond owner	Interest-earning bond backed by full faith and credit of U.S. government	No penalty; interest on redeemed bonds included in federal income
<b>Roth IRA</b>	Not applicable	Withdraw earnings tax-free only after five years and age 59 1/2	Must have taxable compensation; contribution limit phases out for incomes between \$204,000 and \$214,000 (joint filers) or \$129,000 and \$144,000 (single)	Not counted as asset; withdrawals of principal and interest counted as financial aid income	Broad range of securities and certain other investments	Taxable portion of withdrawal prior to age 59 1/2 also subject to 10% early withdrawal penalty
<b>Traditional IRA</b>	Not applicable	Withdraw without penalty only after age 59 1/2	Must have taxable compensation; amount deductible reduced or eliminated for taxpayers who participate in an employer retirement plan and have income above certain limits	Not counted as asset; withdrawals of principal and interest counted as financial aid income	Broad range of securities and certain other investments	Taxable portion of withdrawal prior to age 59 1/2 also subject to 10% early withdrawal penalty
<b>UGMA or UTMA</b>	No; represents an irrevocable gift to the child	Custodianship terminates when minor reaches age established under state law (generally 18 or 21)	None	Counted as student's asset	As permitted under state laws	Funds must be used for benefit of the minor
<b>Mutual Funds</b>	Not applicable	None	None	Counted as asset of the owner	Mutual funds	No restrictions