College Funding Solutions: What's Best for Your Clients?

What's the best way to save for college? Naturally, the answer will be different for every client. In fact, when you think about it, developing an individualized college funding plan requires evaluating more personal variables than for any of your clients' other financial goals. You need to consider their net worth, investment savings, risk tolerance, age, employment, even the number and ages of their children. You must also address whether clients want to fund a public or private education, if they are candidates for federal financial aid, and whether they view college costs as a parental or shared family responsibility. Additionally, the steady increase in college tuition and fees, the relatively short investment time horizon, and changing tax laws, can further complicate planning.

Because many parents view funding their children's education as the most important investment they will make, your clients may look to you for help in developing a college savings plan. Your expertise and guidance can reduce their stress and enable them to meet their goals, enhancing your relationship. What's more, college planning work often opens the door to estate planning discussions and results in a practice-building bridge for you to connect with the next generation.

So, give it the old college try. Follow these steps to determine which college savings product best aligns with your client's overall portfolio and investment goals:

COMPARE COLLEGE SAVINGS PRODUCTS

Your work begins with evaluating the wide range of college savings products and strategies—and that can make you feel like you stepped into the pages of *Goldilocks and the Three Bears.* Whether your clients are looking for tax efficiency, a broad range of investment options, control over assets, or account flexibility, it seems no one product fits just right, and for every benefit, there is a trade-off.

If your clients decide to save in mutual funds, for example, they can choose from a full range of investments and have complete control over how their money is ultimately spent. However, while mutual funds might appeal to sophisticated investors who tend to trade often, these funds are subject to capital gains taxes, a particular concern in a rising tax environment. Traditionally, clients who primarily desire tax efficiency have invested in custodial accounts like the UGMA (Uniform Gift to Minor's Act) or UTMA (Uniform Transfer to Minor's Act) where assets held in the child's name are taxed at the child's tax rate (as opposed to the parents' higher tax rate) on the first $2,000 in income before the "kiddie tax" kicks in.[1] However, your clients may have concerns about giving control of money meant for education to their children. And, the income tax benefit of saving in a child's name often could be offset by a reduction in any future financial aid package.

Since 1997, college savings products such as the Coverdell Education Savings Account and 529 College Savings Plan have offered additional tax advantages. Particularly attractive to investors who prefer separate college savings accounts, Coverdells and 529 plans grow tax deferred and qualified distributions are federal tax free. Also, these savings accounts have little impact on qualifying for federal financial aid. Of course, the price for those benefits is the loss of some flexibility. For instance, investors cannot deduct account losses and 529s allow just one investment change per year. And that's just the beginning of a long list of pros and cons.

For example, Coverdell Savings Accounts allow investments in a broad range of securities, including real estate. However, with a contribution limit of just $2,000 a year, it's difficult to amass a significant amount of money to pay for college, when four years at a private university can cost well over $200,000. Additionally, the ability to contribute to a Coverdell phases out for parents with adjusted gross income (AGI) over $110,000 (single) $220,000 (joint) filers.

529 advantages include high maximum contribution limits set by the plans themselves, as high as $300,000 per beneficiary. Further, individuals can gift up to $70,000 ($140,000 per married couple) to a beneficiary in a single year without incurring a gift tax. As with the Coverdell, 529 assets remain under parental control, and account owners can reclaim 529 assets at any time by paying taxes and a 10% penalty on account gains, or simply transfer the account to another beneficiary. However, investors must choose from the limited menu of investment strategies offered by the state-run 529 programs.

Figure 1 summarizes the differences between each of these four investment options.

FIGURE 1: COMPARE COLLEGE SAVINGS OPTIONS

YEAR 2013 RULES	529 PLAN	COVERDELL EDUCATION SAVINGS ACCOUNTS	UGMA/UTMA CUSTODIAL ACCOUNTS	MUTUAL FUNDS
FEDERAL INCOME TAX	Non-deductible contributions; withdrawn earnings excluded from income to extent of qualified higher education expenses	Non-deductible contributions; withdrawn earnings excluded from income to extent of qualified higher education expenses and qualified K-12 expenses before 2013 also excluded	Earnings and gains taxed to minor; first $1,000 of unearned income is tax exempt; unearned income over $2,000 for certain children through age 23 is taxed at parents' rate	Earnings and gains taxed in year realized; special lower tax rates for certain dividends and capital gains
FEDERAL GIFT TAX TREATMENT	Contributions treated as completed gifts; apply $14,000 annual exclusion, or up to $70,000 with a special gift tax exclusion that permits *five years' worth* of gifts in a single year	Contributions treated as completed gifts; apply $14,000 annual exclusion	Transfers treated as completed gifts; apply $14,000 annual gift exclusion	No gift involved; direct payments of tuition not considered gifts
FEDERAL ESTATE TAX TREATMENT	Value removed from donor's gross estate; partial inclusion for death during a 5-year election period	Value removed from donor's gross estate	Value removed from donor's gross estate unless donor remains as custodian	Value included in the owner's gross estate
MAXIMUM INVESTMENT	Established by the program; many in excess of $300,000 per beneficiary	$2,000 per beneficiary per year combined from all sources	No limit	No limit
QUALIFIED EXPENSES	Tuition, fees, books, supplies, equipment, special needs; room and board for minimum half-time students	Tuition, fees, books, supplies, equipment, special needs; room and board for minimum half-time students; additional categories of K-12 expenses	No restrictions	No restrictions
ABLE TO CHANGE BENEFICIARY	Yes, to another member of the beneficiary's family	Yes, to another member of the beneficiary's family	No; represents an irrevocable gift to the child	Not applicable
TIME/AGE RESTRICTIONS	None unless imposed by the program	Contributions before beneficiary reaches age 18; use of account by age 30	Custodianship terminates when minor reaches age established under state law (generally 18 or 21)	None
INCOME RESTRICTIONS	None	Ability to contribute phases out for incomes between $190,000 and $220,000 (joint filers) or $95,000 and $110,000 (single)	None	None
FEDERAL FINANCIAL AID	Counted as asset of parent if owner is parent or dependent student	Counted as asset of parent if owner is parent or dependent student	Counted as student's asset	Counted as asset of the owner
INVESTMENTS	Menu of investment strategies as developed by the program	Broad range of securities and certain other investments	As permitted under state laws	Mutual funds
USE FOR NON QUALIFYING EXPENSES	Withdrawn earnings subject to federal tax and 10% penalty	Withdrawn earnings subject to federal tax and 10% penalty	Funds must be used for benefit of the minor	No restrictions

Source: Savingforcollege.com.

Reviewing each product's benefits and restrictions is time consuming, but your discussions with clients can help illuminate their college savings goals and the path to integrating college funding into the total portfolio.

CONSIDER A 529 PLAN THE COLLEGE SAVINGS CORE

For families who can afford to save all or a substantial portion of expected future college costs, the 529's tax advantages (including income tax deductions in some states) and high contribution limits may make it the best investment vehicle for the bulk of college savings.

In fact, although the recent market downturn highlighted some of the 529's disadvantages, including the inability to deduct losses and limiting rebalancing to only once a year, as the market has started to recover, net flows into 529 college savings plans have increased over the past two years by 75%.[2] According to the Financial Research Corporation (FRC), 529 assets stood at $180 billion as of March 31, 2013 (excluding prepaid plans), up 7.0% from $168.5 billion as of December 31, 2012.[3]

So how do you choose a 529 plan, given the many options available? Look at your client's state's 529 plan first, because although federal taxation doesn't vary between the different plans, some states offer tax deductions for their residents, says Joe Hurley, CPA, founder and CEO of Savingforcollege.com, a company that provides information and consulting services relating to 529 plans and author of *The Best Way to Save for College—A Complete*

Guide to 529 Plans. "I encourage people to shop around to compare the investment managers, fees and expenses, and rules between plans," says Hurley. "For instance, a few plans won't permit other family members to make contributions. Other states don't allow you to change account owners."

Hurley's Savingforcollege.com offers a comprehensive section on how to research and compare different 529 plans side by side based on 30 features or to select specific plan offerings and view how all 529s stack up. For example, you might be interested in how your state's mutual fund plan compares with SSgA's Upromise 529 plan that is comprised of exchange traded funds (ETFs). Or you might want to evaluate all 529s based on their maximum contribution limits, state residency requirements, and fees and expenses. When evaluating each state's individual plan offerings, Hurley likes the age-based options. "Unless you have a reason for customizing a plan, the age-based portfolios work well," he says. "Investing more conservatively can keep you relatively insulated from the volatility of stocks. That's increasingly important the closer the student is to college age."

Hurley also points out that combining 529 plans with other tax-advantaged college savings vehicles, such as a Coverdell or investments placed in the child's name under the Uniform Transfers to Minors Act, can lend a valuable dimension to a college savings strategy. "Maximizing the tax efficiency and flexibility of your client's college savings requires taking advantage of the unique benefits of each investment vehicle," he says. Accordingly, you might create a college savings account with the following investment products:

- Use 529 plans that offer low-cost index funds or ETFs for the majority of assets, or the core of college savings.
- Direct the more limited annual contributions allowed ($2,000) in a Coverdell Education Savings Account (ESA) to higher-risk/potentially higher-reward investments, such as individual stocks, which are not available in 529 plans.
- Invest a modest amount in investments that throw off interest and dividends in custodial accounts where assets can be used for any purpose such as education, travel, a car, etc. and gains could be taxed at the child's lower income tax rate.

INCREASE THE 529'S TAX EFFICIENCY WITH FIXED INCOME

If you manage assets holistically like Glenn Frank, CFP, CPA/PFS, Director of Investment Tax Strategy at Lexington Wealth Management in Lexington, Massachusetts, locating assets in the appropriate taxable or non-taxable accounts, the 529 can deliver even greater tax efficiency.

Organizing assets in a spreadsheet he calls the Family Investment Matrix, Frank directs:

- Buy-and-hold equities, most index funds and most ETFs to taxable accounts.
- High yield bonds, REITs and high turnover managers to tax deferred accounts, like 529s.

"Most investors look at their assets in various pots, or buckets—the retirement money is here and the college money is over there. That's a nice mental shortcut that enables them to tuck the college account away, but in reality everything is extremely interrelated," Frank says.

While behavioral finance has shown it's easier to save when working toward a specific goal, Frank says it's the advisor's job to evaluate and present the client's big financial picture to maximize family after-tax wealth. That requires determining the proper location for each asset based on how each account will be taxed for both income and estate tax purposes.

In situations where the parents plan to make up any college savings shortfall and fund the total cost of college, Frank insists the 529 account should not be viewed in isolation as "college money." Instead, he says, "Investing part of the family's fixed income allocation in a tax deferred, federal tax free 529 is a great way to avoid the interest associated with this asset class being taxed as ordinary income."

For a family's overall portfolio, Frank has targets for conventional fixed income as well as satellite, high yield and floating rate and invests part of the conventional bond allocation in 529 plans to manage taxes."As interest rates could rise from historic lows, shorter term bonds, which will drop less when rates go up, may be the prudent choice within the 529 plan," he explains. "In a normal interest rate environment, higher yielding, intermediate-term bond funds would be our preference."

Frank notes that the younger the client, the more sense it makes to house the highest taxed investments in tax deferred accounts. "Decades of growth with zero tax interference can be tremendously beneficial," he notes. "In fact, the parent can also decide not to use the 529 for college and pay the 10% penalty plus income taxes on the account's gains. If the account was held for several years or more, the savings from tax deferral could more than offset the penalty for unqualified withdrawals."

Frank points out that not every client is a candidate for investing in fixed income in their 529. "The parents' asset allocation could be 80/20 or 90/10 equities/fixed income or the ability to allocate to fixed income asset classes could be limited by 401k choices," he notes. "This approach also can be a tough sell for clients who want to invest in equities in a 529 for young children with the notion that they have a decade or more of growth to look forward to."

The key to success with investing in fixed income in a 529 account is judging whether you have time to tell the "whole story," says Frank. "Some clients have the attention span and some don't—and some people will always have a difficult time letting go of a return-oriented college portfolio," he concludes. "This whole business is based on conventional wisdom. So, if you say something that makes sense that is unconventional, such as locate fixed income in a 529, it can be a real practice differentiator."

THINK OUTSIDE THE 529 BOX

529 plans aren't for everyone. While a 529's tax deferral gives your assets a chance to grow faster than they would in a comparable taxable account, Frank says it's important to keep in mind that buy and hold equities (individual stocks, ETF's, tax managed mutual funds, index funds) generally generate very little in the way of ordinary income during the accumulation years. And, as a bonus, you can harvest losses along the way to offset current portfolio gains or to carry over to offset future gains.

"Even if the costs were comparable, when you factor in the ability to take losses and trade on a regular basis, some parents would be better off saving outside a 529," explains Frank. "With the large array of ETFs and/or index funds available, parents who want more investment choices and control than 529s offer could put together a very well diversified portfolio at costs that are less than many 529 plans and where funds don't have to be used for education." Frank also points out that a buy and hold portfolio of equity mutual funds can curtail clients' worries about overfunding a 529 and having money left over or having to go through the hassle of naming another beneficiary if the child that the account was opened for does not attend college.

Frank designates these inherently tax efficient investments for college by noting the child's name or "college savings" in the address line. "Emotionally it makes the parents feel better to label something like Kids' College Fund, the pot mentality dies hard," he says. "The shares can be gifted to the child who would then sell them and pay a modest capital gains rate. However, if the student receives financial aid, you will want to wait until the last year of college as the gift of appreciated stock would count against the student in the financial aid calculation."

On the other end of the spectrum, Hurley points out that investors who don't pay income taxes or who are in the 15% tax bracket may be better served by a taxable fund. "529 plans charge an administration fee that other investment accounts do not," he explains. "And for investors in a low bracket, tax-free distributions are less of an advantage. No tax is better than a low tax, but it's worth doing the math to figure out if tax savings outweigh the extra costs."

The same warning holds true for investors getting a late start on college saving in a 529. "Assets for high school students would obviously be invested in fixed income or CDs, so there is less potential for clients to benefit from federal tax-free compounded growth," explains Hurley.

FOR GRANDPARENTS—529S ARE A GREAT ESTATE PLANNING TOOL

With the favorable estate tax laws in place only until the end of 2013, now is an ideal time to review estate tax strategies—and 529s—with clients who are grandparents. In a rare estate planning win/win, grandparents' 529 contributions are immediately removed from their taxable estate, yet they retain full control over the assets, including the right to take the money back at any time. "No other investment vehicle affords this combination of control and estate reduction," notes Hurley.

Here's how it works: You know the annual limitation for tax-free gifts to family members is $14,000 per individual per year for 2013. However, a special gift tax exclusion permits *five years' worth* of gifts to the beneficiary of a 529 plan, in a single year, without triggering the federal gift tax. That amounts to $70,000 for individuals and $140,000 for married couples.

The beauty of this move for grandparents—or aunts, uncles, or even older siblings—is that while 529 contributions remove assets from an estate for tax purposes, the gifting family member retains control of the assets. Explains Frank, "A client may be reluctant to utilize his $14,000 annual gift exclusion because he worries he may need the money back one day. That concern disappears with a 529 plan. Although opening the 529 moves assets immediately out of his estate, he retains control of the account. In fact, he can take the money back whether he really needs it or if he just changes his mind later on. Of course, if he takes the money back it comes back into his taxable estate and any withdrawals not used for the beneficiary's qualifying higher education expenses would be subject to taxes and a 10% penalty on the earnings."

What's more, in a double bonus for student beneficiaries, assets held inside a grandparent-owned 529 account are not currently included in the calculation to determine a student's eligibility for federal financial aid. It is only when a student takes a qualified distribution for college that the amount will need to be reported as student income on federal aid forms.

TAKE A CRASH COURSE ON FINANCIAL AID

Even if you anticipate that many of your clients won't come close to qualifying for federal financial aid, they are going to ask you financial aid questions. And you need to be prepared with the answers. These three steps can acquaint you with the financial aid process:

1. LEARN ABOUT THE ESTIMATED FAMILY CONTRIBUTION (EFC)

To ensure that your college savings strategy does not negatively impact your client's child's federal financial aid eligibility, you have to understand how the Estimated Family Contribution (EFC) federal formula works.

The EFC counts the following financial resources as being available to pay college expenses:

- 20% of a student's assets (money, investments, UGMA/UTMA accounts business interests, and real estate)
- 50% of a student's income (after certain allowances)
- 2.6%- 5.6% of a parent's assets (money, investments, certain business interests, and real estate, based on a sliding income scale and after certain allowances)
- 22%-47% of a parent's income (based on a sliding income scale and after certain allowances)

Note that the EFC factors in 529 plans as a parent asset. However, private colleges are free to do anything they want with their own money, and can reduce their own scholarships for students with money in a 529. "If you think there's a possibility of merit aid, and your student is very interested in a particular college, it would be wise to check on the school's policy toward 529s even before the student applies," says Hurley.

It's also important to know that the EFC excludes these resources:

- Qualified Retirement Accounts such as an IRA or 401(k), whether owned by parents or students
- Equity in a primary home or a family-owned business
- Insurance policies and annuities

2. GET INTRODUCED TO THE FAFSA

To apply for student financial aid from the federal government, including the Pell Grant, Perkins Loan, Stafford Loan and work-study, your client will need to submit the Free Application for Federal Student Aid (FAFSA). There is no charge for submitting this form.

Some private colleges and universities also require one or more supplemental forms, often the College Board's CSS PROFILE, a more detailed form with a fee.

While the FAFSA cannot be submitted before January 1, deadlines vary from school to school. So, you should review important information about the deadlines on college websites. If you have questions be sure to call the financial aid office as it is crucial not to miss these deadlines.

3. UNDERSTAND THE RULES GOVERNING WITHDRAWALS FROM COLLEGE SAVINGS ACCOUNTS

In the college savings realm, rules and regulations extend beyond accumulation mode. For example:

- Taking money out of your IRA to pay for college—although permitted penalty-free from a traditional or Roth IRA to pay for qualified college costs—could jeopardize financial aid in the following year because the entire withdrawal, principal and earnings, counts as income on the following year's aid application.
- When used for college, withdrawals from 529 plans and Coverdells are excluded from your federal income tax return, and are not required to be "added back" when reporting your family income on the FAFSA.
- Leftover money in a 529 can be transferred to another beneficiary—or even put in the account owner's name.

Finally, it's also important to set financial aid expectations early. That is, while it's always possible that a student will qualify for merit aid that is not determined by the federal formula, Frank estimates that if a family earns upwards of $150,000 and has investments of any kind outside of retirement accounts, subsidized federal financial aid is a long shot. Sharing this level of detail with clients can help set realistic expectations and motivate them to save.

Source: Savingforcollege.com

"Most financial aid offices interpret the rules as requiring distributions from grandparent-owned 529s to be included as student income, even when the distributions are not reportable for federal income taxes," explains Hurley. "For that reason, many families view grandparent-funded 529s as the last asset to be tapped for college. That is, the student uses the 529 for senior year, because the student would not be applying for financial aid in the following year."

If you have wealthy clients who don't yet have grandchildren, they can still move money out of their estate by investing in a 529 college savings plan. In fact, it's permissible for an investor to set up an account with themselves as the initial beneficiary and transfer it to their future grandchild at some later point in time. However, there are a few caveats to this approach. "Setting up the account for yourself as the beneficiary does not remove the asset from your estate until you change the beneficiary," Hurley notes. "And although beneficiary changes are restricted to other family members of the initial beneficiary, there are no limits on the number or frequency of beneficiary changes."

Finally, clients who do not need the required minimum distributions (RMDs) from their retirement accounts to meet expenses might consider directing those assets to a 529. Yes, taxes will be owed on the RMDs, but by investing those assets in a 529 they can begin to grow tax free for college. Note that this approach would also work for parents who are 59½ before their child graduates from college.

Frank concludes that the 529's flexibility as an estate planning tool facilitates discussions about family wealth, "Heirs don't want to seem like hovering vultures, so often times estate planning is never fully addressed," he observes. "However, the discussion is much easier when you are talking about funding college education. When grandparents understand how investing in a 529 college savings plan could help fund college and reduce a future tax burden by lowering the amount of their estate, their eyes light up. And parents like the fact that savings in the grandparents' name doesn't hurt their child's chances of getting federal financial aid."

STAY TUNED AND TRACK TRENDS

Although education is lauded as the "great equalizer" in America, a college education is getting more difficult to afford for many families, making loans more prevalent. In fact, according to the Institute for College Access & Success (TICAS), an Oakland, California policy research group, American's more than $900 billion in federal and private loans surpassed outstanding credit-card debt for the first time in 2010. And two-thirds of the college Class of 2010 graduated in debt, owing an average of $25,250, up 5% from the previous year.[4]

However, there are some bright spots in college funding. The number of colleges with a "no-loans" policy, which guarantees aid in the form of grants rather than loans to meet a family's demonstrated financial need, continues to grow. Also, many universities are offering more merit scholarships to attract top students, although with an increase in merit aid comes a decrease in funding for need-based aid.

As college costs and competition for admission continue to increase, providing the best advice to your clients, demands that you develop a college savings strategy that responds to college funding trends and effectively utilizes the wide range of investment products. Above all, however, you should follow the same advice you give to clients who are saving for college: start planning early. Providing a college education is a big dream with a big price tag—and anything your clients can save will open doors for their children and is money they won't need to borrow later.

Today, more high school students are going to college than ever before.[5] The market crisis of 2008 and ongoing market volatility have increased parents' concerns about how to pay the bills. This creates a unique opportunity for you to provide college funding expertise. By explaining when to use a 529 college savings plan, connecting college funding to clients' broader portfolio and reaching out to grandparents and other family members who may want to help finance college, you can pave the way for your clients to achieve one of their most important financial goals. Your work will also deliver real benefits for your practice—stronger client relationships that can result in more referrals and, most significantly, meaningful connections with your clients' children.

ABOUT THE 529 EXPERTS

GLENN FRANK, CFP®, CPA/PFS, Director of Investment Tax Strategy, Lexington Wealth Management, Lexington, Massachusetts, develops customized financial and investment related tax strategies for clients and contributes to the overall investment decisions of the firm. With more than 20 years of experience in investment consulting and financial planning, Glenn has been consistently recognized by *Worth* magazine as one of the country's top Wealth Advisors. He is the Founding Director of the Master of Personal Financial Planning program at Bentley College, a member of the program's advisory board and teaches two graduate level courses within the program. Glenn received his MBA from West Virginia University graduating with high honors, and a Masters of Science in Taxation (MST) from Bentley College graduating with high distinction. He is a Certified Financial Planner™ Professional (CFP) and a Certified Public Accountant with a designation as a Personal Financial Specialist (CPA/PFS).

JOE HURLEY, CPA, Author of *The Best Way to Save for College—A Complete Guide to 529 Plans* and founder of Savingforcollege.com LLC, a firm that provides information and consulting services relating to 529 plans, has become known as the "529 Guru." A former tax partner at Bonadio & Co. LLP, an upstate New York accounting firm, where he provided tax-planning services to individuals, corporations, and tax-exempt organizations, Hurley now spends all his time researching, writing, speaking, and consulting on the topic of 529 plans and other college-planning issues. His articles have appeared in *The Journal of Accountancy* and *The CPA Journal.* He conducts regular 529 boot camps to educate advisors and has appeared at Congressional hearings to provide comments on proposed regulations under Section 529. One of nine individuals recognized by Financial Planning magazine as 2005's "Movers and Shakers," Joe began his career with Peat, Marwick, Mitchell (now KPMG), in New York City. He graduated from Williams College with degrees in economics and psychology.

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[1] http://www.irs.gov/pub/irs-pdf/p929.pdf, as of 6/30/2013
[2] http://www.frcnet.com/documents/Investors-Make-529-College-Savings-Plans-a-Priority-New-FRC-Study.pdf
[3] http://www.savingforcollege.com/529_news/index.php page=plan_news&plan_news_id=1221
[4] http://www.consumerreports.org/cro/magazine/2012/04/student-debt-grows-to-alarming-levels/index.htm
[5] http://nces.ed.gov/programs/coe/overview.asp

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