FCS3353

Strategies to Fund Your Child's College Education: Using Savings and Tax-Advantaged Vehicles[1]

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Introduction

The average annual cost of tuition and fees is $33,480 at private colleges, $9,650 for in-state students at public universities, and $24,930 for out-of-state students at public universities (CollegeBoard, 2019). This brings us to the importance of planning for college education. It is never too soon to explore funding options for college educations, whether your child is a newborn or is in middle school. You are more likely to be prepared to fund your child's education if you start planning earlier.

This publication describes and discusses the following accounts that allow you to pay for college while taking advantage of tax and savings opportunities:

1. College Savings
2. UGMA/UTMA Assets
3. Coverdell Education Savings Accounts (CESA)
4. Traditional or Roth IRA
5. The Health and Education Exclusion Trust (HEET)
6. Crummey Trust
7. Series EE and Series I Savings Bond

529 College Savings Plans

What is a 529 plan?

- A 529 plan is a tax-advantaged saving plan (also known as a "Qualified Tuition Plan") that is sponsored by states, state agencies, or educational institutions.
- After tax money is invested into the plan and withdrawals are used for qualified higher education, expenses are tax-free. Earnings are not subject to federal tax.
- Two types of 529 plans exist:
- Prepaid Tuition Plans
- Education Savings Plans
- Be sure to explore your options and ask about annual fees and operating costs up front.
- More than 30 states in the US offer these plans, which vary for each state. You do not have to purchase in your own state, but it may still be the best option.

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Table 1. Prepaid plan.

Advantages	Disadvantages
Buying future tuition credits and mandatory fees at the current tuition rate to avoid climbing prices.	Might not be able to use for room and board. Purchased for eligible schools. If your child does not attend one of those universities, you get your money back, but it may not have grown much.
Depending on your state, contributions are often tax-deductible and earnings that grow are tax-deferred.	Most require residency in the state of purchase.
Most plans are sponsored or guaranteed by the state.	Not guaranteed by the federal government. If the plan's sponsor has a financial shortfall, you may lose some or all of your money.
Most set lump sum and installment payments prior to purchasing the plan based on the age of the beneficiary and the number of years of tuition being purchased. Easy to plan.	Most have limited enrollment period and age limits on the beneficiary.

Table 2. Education savings plans.

Advantages	Disadvantages
No residency requirement or age limits. Enrollment open year-round.	Sponsored by state, but not backed by a state guarantee. Subject to market risk and could potentially decline in value.
Covers all "higher education expenses" which include tuition, fees, room and board, and textbooks.	The tuition price is current, not locked at the time of opening the account.
Note: This type of account is viewed as your asset, not as your child's asset. This fact will become important when your child is being considered for financial aid.	

UTMA/UGMA Accounts

What do these letters stand for and what do they mean?

- Uniform Transfer to Minors Act Account and Uniform Gift to Minors Act Account
- These are custodial accounts that essentially act as a trust for your child. They can contain stocks, bonds, annuities, cash, and other assets reserved for your child until they come of age.
- Any money in these accounts will be counted as a part of the taxable estate of the custodian before the child reaches the age of trust termination.
- The income from a custodial account must be reported on the child's tax return at the child's rate as determined by the Kiddie Tax rules.

Table 3. UTMA/UGMA Accounts

Advantages	Disadvantages
Can contribute as much as you want (amounts above $14,000 per year will incur federal gift tax). Earnings will be taxed at the child's rate.	No state deductions received for money contributed. You will not be exempt from taxes on the earnings.
Anyone can open or contribute on behalf of a child.	Significant impact on financial aid. The account belongs to the child, and 20% of the money will count against financial aid.
No penalty if the assets are not used for college.	No restrictions on the use of the money. When the minor becomes an adult, they are free to use the money for any purpose.
Note: This type of account is viewed as the asset of your child. This fact will become important when your child is being considered for financial aid and may affect the amount of aid offered.	

Coverdell Education Savings Account (CESA)

What is a CESA?

- A trust or custodial account that is established to pay for a beneficiary's qualifying education expenses.
- Recognized as an asset owned by the beneficiary, who can use the principal interest to pay for qualified expenses (tuition, fees, books, supplies, and room and board).

Table 4. Coverdell Education Savings Account (CESA)

Advantages	Disadvantages
Distributions are tax-free as long as they do not exceed the cost of education.	Contributions are limited to $2,000 per tax year.
The beneficiary can claim the Hope Credit or Lifetime Learning Credit for qualified education expenses even if they are withdrawing from a CESA.	Beneficiary cannot claim the credit for the *same* educational expenses covered by a CESA.
Accounts of beneficiaries with special needs are not subject to age restrictions on contributions and withdrawals.	Beneficiary must be under 18 years of age when the account is established. If the balance is not used prior to the beneficiary's 30th birthday, account owner will incur tax and penalty fees.

Traditional or Roth IRA

What is an IRA?

- IRA stands for individual retirement account. Most people think that these accounts are simply great ways to save for retirement. However, the accounts can also be used to cover educational expenses.

Table 5. Traditional or Roth IRA

Advantages	Disadvantages
Withdrawals from IRAs, including Roth IRAs, are exempt from the 10% early withdrawal penalty if the amount is used specifically for qualified educational expenses (tuition, fees, room and board).	Only contribution portions of the traditional IRA balances can be withdrawn tax-free for educational expenses. Anything withdrawn that exceeds the total contributions (earnings) will be taxable for those younger than 59.5 years old.
Leftover funds after withdrawal for educational expenses can be converted into retirement income.	Contribution limit is $5,500. Retirees may not be able to partake as they must have earnings to contribute.
Can be passed on to heirs.	Individuals with income exceeding $114,000 are prohibited from using a Roth IRA.

The Health and Education Exclusion Trust (HEET)

What is a HEET?

- A trust established either during an individual's lifetime or by their will upon death to provide payments for medical expenses and educational expenses for their descendants (two or more generations younger).
- Designed to minimize the generation-skipping tax (GST).
- This method is appropriate for grandparents seeking to make transfers to their grandchildren.

Table 6. The Health and Education Exclustion Trust (HEET)

Advantages	Disadvantages
Allows funds to be paid to benefit the grandchildren even if the owner of the trust may have used up their generation-skipping exemption.	Funds from the trust must be paid directly to the educational institution itself for tuition.
No limitation on the amounts that can be paid for tuition and medical expenses.	Cannot be used for parent-to-child giving.

Crummey Trust

What is a Crummey trust?

- A trust established to gift money to a minor while maintaining a certain degree of control over how the assets are distributed.

Table 7. Crummey Trust

Advantages	Disadvantages
Gives the donor control over the timing of the distributions. Accumulated trust assets can be held in trust for the beneficiary until they are more mature.	Each time a donor contributes to the trust, a notice of a right of withdrawal must be provided to the beneficiary or guardian, and they have about 30 to 60 days to act.
No penalty if funds are used for expenses other than higher education.	Expensive to set up because it is a more complex method and must be drafted by an attorney.
This trust can have multiple beneficiaries.	This type of trust may affect the beneficiary's ability to qualify for financial aid because the distributions are considered income.

Series EE and Series I Savings Bond

What are Series EE and Series I Savings Bonds?

- Two series of savings bonds currently offered by the US Treasury.
- Can still purchase paper Series I bond with a tax refund at face value; paper Series EE bonds are no longer available.
- Both can be purchased in electronic format for face value for any value over $25 to the penny (e.g., a $50 bond would cost you $50).
- The savings bond education tax exclusion permits qualified taxpayers to leave out partial or full interest paid upon redeeming the bonds (purchased after 1989) from their gross income, when the bond owner pays for qualified educational expenses within the same tax year in which the bonds were redeemed.

Table 8. Series EE and Series I Savings Bond

Advantages	Disadvantages
Both principal and interest can be cashed in tax-free for paying college tuition for the beneficiary.	Qualified expenses include only tuition and fees. Room and board and books are not eligible.
$15,000 limit for single clients and $30,000 for married couples.	Early withdrawal penalty associated with the bonds in the first five years.
	These bonds offer a low rate of return.
	The interest income exclusion is phased out at higher income levels, based on the adjusted gross income. For 2018, the exclusion completely phased out at $92,000 if filing single and at $147,750 if filing jointly. Note that these limits vary by year.

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