COLLEGE PLANNING

FOR YOUR CHILDREN (AND GRANDCHILDREN)

IT IS NEVER TOO EARLY TO BEGIN PLANNING FOR COLLEGE AND CONSIDERING YOUR SAVING OPTIONS FOR YOUR LOVED ONES—IN FACT, THE EARLIER THE BETTER.

Most Americans would do almost anything for their offspring and sending them to college is a top priority for many. According to studies, more than 50% of parents are willing to go into debt to fund their child's college education.

The trouble is, college debt is extremely high—currently $1.76 trillion, though the Biden administration is trying to forgive about $500 billion of that total. The average student loan debt amount is now $37,574 according to the most recent data.

Why is it so high? Well, for one thing, the average in-state tuition and fee price at public four-year institutions is $10,440 in 2023—per semester. That is about three times as high as it was in 1989-90, according to the College Board.

SO, WHAT IS A LOVING PARENT OR RELATIVE TO DO?

FOR ONE THING, START SAVING NOW. HERE ARE SOME OF YOUR OPTIONS.

529 PLANS

A 529 plan, technically known as a "qualified tuition program" under Section 529 of the Internal Revenue Code, is an education savings plan offered by all 50 states and the District of Columbia. There are generally two types—prepaid tuition which allows you to lock in today's tuition rates for the future college attendee, and the more popular 529 savings plan.

Keep in mind that you aren't restricted to your own state's plan. You can invest funds in any state's plan, and your student can attend college in any state. Each state's 529 plan is unique, with a different combination of sales channels, investment offerings and fees—including loads for broker-sold plans, enrollment fees, annual maintenance fees and asset management fees. Because of this, it pays to shop around when choosing a plan because even if your state offers a tax deduction or credit for contributing to your state's plan, that benefit might not stack up against the performance or lower cost of another state's plan.

PROS OF 529 PLANS

Although contributions to a 529 plan aren't tax deductible on your federal tax return, the earnings grow tax-free when withdrawn and used for qualified education expenses. Qualified education expenses include college tuition, room and board fees, or textbooks. And as of passage of the Tax Cuts and Jobs Act of 2017, also allowed are up to $10,000 per year for K-12 education expenses such as private school tuition or tutoring.

Many states offer state income tax deductions for contributions if you choose to invest in your state's plan. (Your child can still attend college anywhere.) But each state has its own tax rules regarding their 529 plans so it's important to get advice from a tax professional who is well-versed in the applicable state.

There are no income limits on 529 plan contributions, so they're available to everyone. Plans vary, but most have high total contribution limits—usually in the $235,000 to $529,000 range. That said, it's usually best to keep yearly contributions within the federal annual gift tax exclusion limit. For 2023, that's $17,000 for each parent (or grandparent, relative, friend or any giver) for each student.

CONS OF 529 PLANS

The 529 plan is counted as an asset on the FAFSA (free application for federal student aid) if it is owned by a parent or the student, although only a percentage of the total account is calculated. Beginning in 2023, if the 529 plan is owned by a grandparent, aunt, uncle or other person, it will be virtually invisible on the FAFSA's calculations for both assets—or for student income later after distributions are taken and used for qualified expenses.

There are limited investment options available with 529 plans, and only one investment change per year is permitted. Some plans have high costs and fees.

If your child, you or any family member does not want to attend college, and if 529 plan money is withdrawn and not used for education expenses, the account's earnings are subject to both income tax as well as a 10 percent penalty tax, and you may have to pay back any state income tax deduction amounts as well.

There are exceptions to 529 plan penalties if your student receives scholarships. And beginning in 2024, per SECURE Act 2.0, a total of $35,000 of unused 529 plan funds may be rolled over into a Roth IRA if the 529 plan has been in existence for 15 years or longer; however, annual Roth account limitations will apply. Clarifications on 529 rollover rules from the IRS and regulatory bodies are expected to be forthcoming.

ROTH IRAS

If a 529 plan doesn't work for your family for some reason, a Roth IRA may be an option. You can withdraw money from Roth IRAs to be used for college expenses for you, your spouse, children or grandchildren as long as the account has been in place for five years. If the account owner is under age 59-1/2, the only tax liability for college expenses will be on the earnings—if over 59-1/2, the entire withdrawal amount is tax- and penalty-free for any purpose.

There is a lot of flexibility with a Roth—you can invest in nearly any type of account you want to within a Roth IRA from CDs, to annuities, to mutual funds, or anything else—but obviously, you will want to find the highest returns and lowest cost/fees. One of the advantages of the Roth IRA is that if your child doesn't choose to go to college, the money can be used for any purpose, including retirement (with no mandated required minimum distributions, ever). Another advantage of the Roth is that beneficiaries can inherit Roth accounts tax-free—they just have to withdraw all the money within 10 years of the date of original account owner's death.

One of the difficulties with Roth IRAs is that high earners can't open them, and the yearly limit in 2023 for contributions is only $6,500 ($7,500 per year for those 50 or older). While a Roth IRA does not show up as an asset for financial aid calculations, amounts withdrawn and used for college expenses are considered income for the next school year, and therefore may reduce the amount of student financial aid that's available during that year.

PERMANENT LIFE INSURANCE

Permanent life insurance policies, such as whole or universal life, include both a death benefit and a savings/cash account component which you can borrow against to pay for college. Many whole life and similar policies regularly credit the cash account with interest in a guaranteed* amount specified in the policy terms (*guaranteed by the claims-paying strength of the issuing insurance company.)

Money borrowed from the cash value in a life insurance policy is not taxable in most cases. Interest accrued in the policy grows tax-deferred but the interest is taxable if that part of the money is borrowed for any purpose. (Like most life insurance policies, in case of death the death benefit plus remaining cash value usually gets paid out to the beneficiary tax-free.)

While a life insurance policy does not show up in financial aid calculations as an asset, amounts borrowed to pay for college are considered as income on the next year's FAFSA, as is withdrawing money from a Roth IRA, potentially reducing the amount of student financial aid available.

Life insurance policies can be costly. If you are using these to pay for college, consider buying the policy when the child is a toddler—with them as the insured to keep the cost of insurance low.

Keep in mind that if you borrow money from the cash portion of a permanent life insurance policy, interest is charged by the insurance company on the amount borrowed until you pay the money back—in essence, you are paying "yourself" back—and regular premium payments must be made to keep the policy in force (unless it is a single premium policy). NOTE: Some policies allow premiums to be deducted from cash value but watch closely because you could end up with no death benefit and owe money to the insurance company.

It is advisable to work with a qualified professional to examine the structure of any policy so that you understand its terms.

ANNUITIES

You can purchase an annuity with a short payout schedule to make payments to cover tuition; you may have to contribute a significant amount to achieve the payout needed. In order to make this work in your favor cost-wise, you might need to start early and purchase a deferred annuity policy which guarantees* a high credited interest rate (*guaranteed by the claims-paying strength of the issuing insurance company.)

While an annuity does not show up on the FAFSA as an asset, annuity amounts paid out are considered income the next year, similar to taking money from a Roth IRA or loan from an insurance policy to pay for college. So rather than taking annuity payments while attending college, optionally you could take out student loans (federal student loans are at around a 7.54% interest rate for Parent PLUS loans in 2023), then use the annuity to pay off the loans after graduation depending on interest rates, crediting rates, and whether or not it saves you money in the long run. Working with a qualified financial and tax professional is advised.

HOW COLLEGE SAVINGS CAN IMPACT FINANCIAL AID ELIGIBILITY

Legislation is always changing for parents looking to get a jump-start in funding their child's education. For example, due to the FAFSA Simplification Act of 2020, beginning in July of 2023, the EFC (expected family contribution) will be replaced by the SAI, or student aid index. Where EFC bottomed out at $0, SAI can go as low as -$1,500, meaning students can qualify for more need-based aid. SAI also simplifies the form itself, drastically reducing the number of questions. Where possible, the new law mandates data received directly from the IRS be used to calculate the SAI and federal Pell Grant eligibility.

Where the new SAI versus the EFC calculation on FAFSA may truly be a boon to students who need more aid is through 529 plans. Beginning in July 2023, 529 accounts owned by grandparents, aunts, uncles or others will not be counted as assets, nor will qualified distributions taken from them be counted as income on the FAFSA and therefore they should have no significant impact on eligibility for financial aid.

FAFSA (FREE APPLICATION FOR FEDERAL STUDENT AID) AND THE CSS (COLLEGE SCHOLARSHIP SERVICE)

While it is true that life insurance, annuities and 529 plans owned by anyone other than parents or students are not counted as assets on the FAFSA, they may be counted on the CSS (College Scholarship Service) Profile, another aid form used for aid by about 240 colleges in addition to the FAFSA. The CSS profile is extremely complex and steps are being taken to simplify it, but changes to the form have not been finalized.

RESOURCES FOR PARENTS

Federal Student Aid Estimator
https://studentaid.gov/aid-estimator/

FAFSA
https://studentaid.gov/

LOGO

Contact Info

ADVISOR DISCLOSURE HERE

This information is for educational purposes only and should not be taken or construed as legal, tax or financial advice. In all cases, it is recommended that you consult with legal, tax and financial advisors who can provide you with personalized advice based on your unique situation and circumstances.

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