

Strategies to make the most of college savings

The cost of college tuition and fees rose 2.9% for public college and 3.6% for a private college in 2015 from 2014, exceeding inflation again, the College Board found.*

Parents looking at college expenses in the future are already prioritizing the need to save as they seek to reduce the debt burden for their children or themselves. For families with children preparing to enter college in the near term, the next challenge is how to spend down those savings in an efficient manner while considering financial aid implications, minimizing taxes, and even reducing investment risk. With a range of savings vehicles and debt options available to help pay for college, it can be a complicated decision when determining which accounts or strategies to utilize and when to make withdrawals.

RISING COST OF COLLEGE (PUBLISHED ANNUAL TUITION AND FEES ONLY)	2005	2015
Public (resident)	\$5,491	\$9,410
Public (non-resident)	\$13,164	\$23,893
Private	\$21,235	\$32,405

Source: The College Board, Trends in Higher Education Series, 2015.

Meeting the challenge of how to spend down college savings

Most families use a combination of options to pay for college, including 529 college savings plans, personal savings, financial aid, and different forms of debt. In its 2016 report, Sallie Mae† found the largest portion of college costs — 34% — is paid from scholarships and grants, followed by parent income and savings (29%), student borrowing (13%), student income (12%), parent borrowing (7%), and relatives and friends (5%). With a focus on saving,

* The College Board, Trends in College Pricing, 2015.

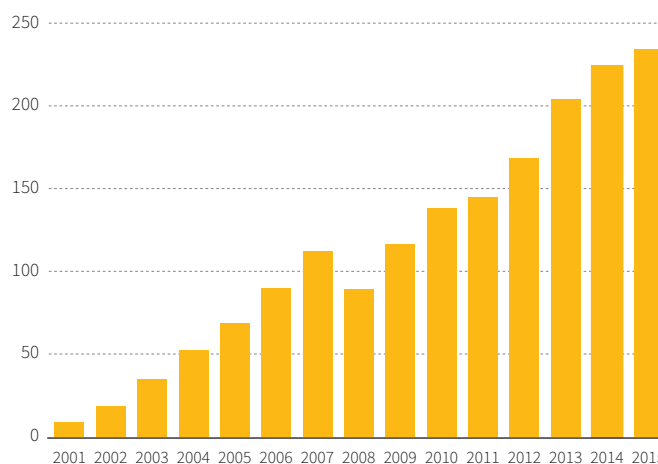
† Sallie Mae, How America Pays for College, 2016.

it is important to understand the benefits and limitations of each investment vehicle in order to prioritize its use based on financial aid or tax considerations.

Among the most popular are 529 college savings plans. Assets in 529 plans have grown substantially for more than a decade and doubled from 2009 to 2015, totaling \$234.2 billion, according to the Investment Company Institute. The number of 529 plan accounts has also risen steadily and totaled nearly 11.1 million at the end of 2015.

State 529 plan assets

■ Billions of dollars



Source: Investment Company Institute and College Savings Plans Network, 2015.

How college savings are utilized in combination with other accounts — and the timing of distributions — can make a difference on the longevity of assets and financial aid eligibility. For college savings, a drawdown strategy should be a priority.

Financial aid eligibility

Financial aid is an important piece in meeting college costs, and most families seek aid through the Free Application for Federal Student Aid (FAFSA) program. More than half of undergraduate students in 2015 received financial aid, according to the College Board (Trends in Student Aid, 2015), with the average grant totaling about \$8,170.

Ownership of assets is an important consideration when applying for financial aid. Determining whether an asset is a “parent asset” or “child asset” is part of the calculation of the expected family contribution (EFC). Generally, parent assets are treated more favorably than child assets for purposes of financial aid — 20% of the child’s assets are taken into account for purposes of calculating the EFC, while a maximum of 5.64% of parent assets is considered.

Here are some examples of how account ownership is defined:

- College savings accounts such as a 529 plan or Coverdell Education Savings Account (ESA) are considered parent assets (unless owned by a non-parent such as a grandparent).
- Accounts in the child’s name such as savings accounts or custodial Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) accounts are considered assets of the child.
- For purposes of the FAFSA form, non-parent-owned assets, such as a 529 owned by a grandparent, are not taken into consideration as part of the asset test. However, these accounts are included in other financial aid calculations, such as the CSS Profile application used by approximately 300 colleges.

The income test

Parent and student income are also part of the EFC calculation. For example, the FAFSA calculation counts 50% of a student’s income. *This can lead to a drastic reduction in financial aid.* The basic outcome is that the higher the income, the more funds the student will be expected to contribute to college costs. Income is defined broadly and includes sources beyond a workplace wage.

Different types of income that can affect a student’s financial aid award include:

- Qualified distributions from a 529 or Coverdell owned by a non-parent (e.g., grandparent) for the benefit of the child are considered as income to the student.

Here is an example of how these distributions could have a negative impact on a financial aid application:

Consider that 50% of a child’s income is counted toward determining the EFC. If a grandparent withdraws \$20,000 to pay for qualified college expenses, it would be considered income to the student for purposes of the next EFC calculation. In this case, 50% of student income, or \$10,000, is taken into account, which would have a significant impact on financial aid.

- Liquidating investment accounts may lead to capital gains, which would increase income and have a negative impact on aid for that year.
- Roth IRAs (owned by the parent or student) are not included as assets on the FAFSA form, but distributions from IRAs, including Roth, are considered income (even if the distribution is considered “non-taxable,” such as a qualified Roth distribution).

Financial aid planning considerations

There are various planning strategies that families can use to help deal with the asset-ownership issue and mitigate a potential limitation on financial aid eligibility.

- When a student is the beneficiary of a 529 plan owned by a grandparent or other non-parent relative, consider changing ownership to the parent before filing for financial aid. At that point, the account would be reported as a parent asset, but it would be weighed less in the EFC asset test calculation than it would be if it were considered a distribution reported on the income test.
- Avoid tapping into a grandparent-owned account in the early years of college.* During that time, spend down the parent-owned 529 plan first or tap into other sources.
- Avoid liquidating appreciated assets such as mutual funds that may result in large capital gains, which increase adjusted gross income (AGI). This would have a negative affect on financial aid.
- Consider the tax implications of a Roth IRA conversion, which will increase AGI and have an impact on financial aid eligibility. If possible, execute a Roth conversion before college and prior to the tax year that the financial aid application is based on. Also, consider paying the tax bill on the Roth conversion from other assets that may reduce total assets considered for the FAFSA asset test.
- Like a grandparent-owned 529, avoid tapping into a Roth IRA in the early years of college.

* Beginning with the 2017–2018 FAFSA, the base year for student and parent income will be the calendar year two years prior. (FAFSA, 2015)

CONSIDER TAKING ADVANTAGE OF THE HIGHER-EDUCATION TAX BENEFITS THAT ARE AVAILABLE IN THE TAX CODE

- Spend down an UGMA/UTMA first, or even before college, since assets are considered owned by the child, which is more detrimental for financial aid.
- Use UGMA/UTMA funds for expenses that are not considered “qualified college expenses” when using a 529 plan, such as transportation.
- Consider spending down 529 assets in bulk “early” versus spreading them out evenly over four years, and supplementing with other funds or loans. If the 529 is spent early, it may incrementally improve the chances for the student to receive more financial aid in later years.

Tax considerations

It is also important to understand the tax implications of various savings accounts and how their utilization may interact. Here are some tax issues to consider:

- Utilize tax-favored accounts when possible.

A 529 plan and Coverdell ESA provide tax-free withdrawals for qualified education expenses.

With certain savings bonds, a portion of the interest is tax exempt if the money is used for college. This tax advantage is available within certain income limitations for tax year 2016. The exclusion begins to phase out for taxpayers with a modified adjusted gross income (MAGI) above \$77,500 for individuals and \$116,300 for married couples filing jointly. The exclusion is completely phased out at a MAGI of \$92,550 for individuals and \$146,300 for couples.
- Consider the potential tax consequences of liquidating investment accounts, such as the potential to generate capital gains — thus increasing the tax bill for that year.
- Be mindful of penalties. Make sure distributions for college savings accounts like 529 plans match up with qualified college expenses to avoid taxes and a 10% penalty on earnings for non-qualified expenses. It’s also important to remember that qualified expenses for 529 distributions are based on a calendar year, and not on an academic year.
- If there is no financial aid to consider, delay using assets in an UGMA/UTMA account and use tax-advantaged distributions from a 529 plan or Coverdell. Custodial accounts eventually become the asset of the student once they reach the age of maturity. At that time, the student will likely be in a lower tax bracket, minimizing the tax bill, and the funds can be used for any expenses, not just college.

- A. *American Opportunity Tax Credit (AOTC)*: Provides a credit of up to \$2,500 for each eligible student. The credit is not available to taxpayers with more than \$80,000 in income or couples with more than \$160,000. The credit is calculated by including 100% of the first \$2,000 in qualified expenses and 25% of the next \$2,000 in expenses for a max of \$2,500.
- B. *Lifetime Learning Credit*: Offers a maximum credit of up to \$2,000 per tax return. The credit is not available to taxpayers with income of more than \$55,000 (\$110,000 for couples). The credit is calculated based on 20% of the amount of qualified expenses for all students aggregated up to \$10,000 (for a max credit of \$2,000).

It is important to understand how these tax credits work in conjunction with other college savings programs such as a 529 or scholarships. A basic rule to keep in mind is that taxpayers cannot double up on tax benefits for the same college expense. When planning to claim one of the tax credits, the taxpayer must adjust the amount from the total qualified expenses expected to be considered part of a 529 plan distribution. More information on these credits is available from the Internal Revenue Service Publication 970 “Tax Benefits for Education,” <http://www.irs.gov/publications/p970/>.

- C. *Student Loan Interest Deduction*: There is a special deduction for paying interest on a student loan that can reduce the amount of income subject to tax by up to \$2,500. For tax year 2016, this deduction begins to phase out for individual taxpayers with a MAGI in excess of \$65,000 and for married couples with a MAGI of more than \$130,000. The deduction is completely phased out for individuals with a MAGI of more than \$80,000 and joint filers with a MAGI of more than \$160,000.

If the parent has a higher income level and is phased out of the deduction, a loan in the child’s name may take advantage of the income tax deduction once he or she graduates.
- D. *Tuition and Fees Deduction*: This tax provision was extended for tax years 2015 and 2016. The maximum deduction is \$4,000 for individual taxpayers with adjusted gross income of \$80,000 or less (\$160,000 or less for joint filers) for individuals with a MAGI of more than \$80,000 and joint filers with a MAGI of more than \$160,000.

The importance of planning for withdrawals

The overall timing of distributions can vary depending on the type of account and on tax and financial aid considerations. Some accounts have additional benefits that could be lost without a long-term plan. Here are some additional considerations for a college drawdown strategy:

- Utilize a Coverdell ESA before tapping into a 529. A Coverdell can be used for secondary school qualified education expenses, unlike a 529. Also a Coverdell ESA must be redeemed when the beneficiary reaches age 30, unlike a 529, for which future beneficiaries can be named.
- Distribute from the winners first. If holding multiple 529 college savings accounts, consider tapping into the one with the greatest appreciation to lock in gains and maximize the tax benefit since distributions for qualified higher educational expenses are tax-free.
- If there's a chance the child may receive a scholarship in later college years, spend down a 529 college plan. But don't if there are other, younger children because account owners may change the account beneficiary to other family members in the future.
- A Roth IRA may be a good secondary option or "backup plan" to a 529 college savings plan, although Roth distributions may have a negative impact on financial aid. If the funds are not needed, they can be used for tax-free income in retirement.

From saving to drawdown

The process of saving for college can be a complicated one, with multiple strategies offering a range of tax advantages and other benefits. Still, savers need to be mindful of any account limitations and rules that could lead to tax liabilities. Using savings in combination with federal financial aid can pose particular challenges, and there are additional considerations, such as account ownership and income, that can have an impact on financial aid eligibility. To optimize college savings, it's just as important to develop an efficient drawdown strategy as it is to save. At all stages of planning for college costs, seeking advice from a financial professional may contribute to the successful completion of your goals.

Additional strategies to supplement costs

- A home equity line of credit may also be used to help fund a college education. The interest on home equity is generally deductible up to \$100,000 of debt, when itemizing deductions, unless the taxpayer is subject to the Alternative Minimum Tax.
- If federal gift taxes are a concern, consider making direct tuition payments to the institution — these are not considered taxable gifts and do not count toward the annual \$14,000 (per person) gift limit or the lifetime estate and gift exclusion of \$5.43 million.

This information is not meant as tax or legal advice. Please consult with the appropriate tax or legal professional regarding your particular circumstances before making any investment decisions.