North American Management

Financial Planning Note

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Saving for College – Which Approach is Best for Your Family?

For many of us, September turns our attention towards back-to-school activities. If you have college-bound children, dorm room purchases often come with the writing of a significant tuition check. It is no surprise that this time of year we often get questions from parents and grandparents wondering about the best way to save and pay for college for their children or grandchildren.

As college costs have escalated over the years, the number of ways to save for further education has also proliferated. We can now choose between setting up a 529 college savings plan, establishing a custodial account, gifting to a trust, buying zero coupon muni bonds or even purchasing a life insurance policy that builds up cash value.

While zero coupon muni bonds and expensive whole life insurance policies are less appealing these days, the other three choices are worth consideration. Depending on your individual circumstances, here are some pros and cons to each approach:

<u>529 College Savings Plans</u>

The pros: I will admit here that this method of saving for college is my personal favorite. <u>Currently, there is no other mechanism that has as many income tax advantages</u>. Any contributions made to 529 plans will grow tax-free, and any distributions come out of the account tax-free as long as they are used to pay post-secondary school expenses. Some states even give you a tax deduction on the contribution as well.

Moreover, if you are looking to give more than just the annual gifting exclusion from your estate each year (currently $14,000 per person), the IRS allows you to make up to five years of 529 contributions in one fell swoop. You won't be able to make additional contributions for the four years thereafter, but if, for example, you are a couple with two grandchildren, you could gift up to $280,000 in one year using this method.

The cons: 529 accounts are established by individual states partnering with different mutual fund companies. Any investment choices will be limited to the mutual funds offered by a particular plan. Also, while 529 plans are great for those children and grandchildren we know will go to college (and/or graduate school), the tax benefits only apply if the funds are used for that purpose. If you are not certain about the college prospects, or there are other college funds already set aside, a 529 may not be the best choice.

Custodial Accounts (UGMA/UTMAs)

The pros: UGMAs and UTMAs were the saving mechanisms of choice for many parents before 529 plans came along. They allow money to be accumulated for the benefit of a child until they reach the age of 18 or 21, depending on the state in which the account was opened. The investment gains in these accounts have some preferential tax treatment, although not as much as they used to provide. These accounts do have more flexibility than a 529 account. Their use is not restricted for education; there are no limits on what can be contributed to the account; and they can be invested in a wide variety of assets.

The cons: If you don't use the money by the age of majority (18 or 21), your child automatically becomes the owner of the account, whether they are ready to be financially responsible or not. Furthermore, any income generated above $2,000 per year will be taxed at the parents' rate.

Irrevocable Trusts

The pros: Establishing a trust for the benefit of your children or grandchildren can be a good way to get larger amounts of money out of your estate, and provide future generations with a means to pay college tuition. For high net worth clients, this is still a meaningful mechanism to accomplish more complex estate planning goals.

The advantages of a trust are similar to those of a custodial account, with the added benefit that you can customize the terms of withdrawal. Your child will not automatically receive the funds in the trust when he or she turns 18 or 21. You can set restrictions that the funds be used for education. It can also be passed to subsequent generations and/or multiple beneficiaries.

The cons: The time and expense involved in drafting a legal document customized for your specific circumstances may make this less appealing than the simpler custodial account or the 529 plan.

A comparison of the most popular college savings options:

	529 Plan	UTMA	Trust
Cost	Admin/investment fees (most states have low cost options)	Custodial account fees & investment management fees	Legal fees; custodial and investment management fees
Taxes	Tax-free growth and distributions if used for college	Some tax relief for UTMA income below $2,000 per year	No income tax benefit
Estate Planning	Can gift up to 5 years of gift exclusion amount in one year, with certain restrictions in the following years	Can gift up to annual exclusion amount without reporting	Can gift larger amounts as part of complex estate plans
Investments	Limited to particular plan mutual fund options	Flexible	Flexible
Control/Distribution	Owner can be parent or grandparent; for qualified education expenses only	Custodian should be parent; child gains control at age 18 or 21	Trustee has control; distribution dictated by terms of trust

If you have any questions regarding any of the above, or would like to discuss the contents in more detail, please contact your Relationship Manager or me using the information listed below.

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