William Blair

Private Wealth Advisory

Financial Planning Advisory
Education Financing

With college costs rising faster than inflation, planning for education financing is more critical than ever.

Among its many benefits, a college education can have a significant impact on future earning potential. It is an important investment. It is also becoming a more expensive one as increases in college costs continue to outpace inflation.

Fortunately, if you want to help pay for your child's or grandchild's education expenses, numerous financing options are available. These options have various advantages and disadvantages that you must carefully consider to determine the best strategy for your particular situation.

To help you achieve all your financial goals, education planning needs to be integrated into your overall financial plan. Education-financing goals must be weighed against other goals, such as retirement.

This paper will review:

- Rising education costs
- Savings vehicles
- Alternative sources of funding

Rising Education Costs

While the value of a college degree continues to have a significant impact on future earning potential, the published cost of this investment has been increasing consistently faster than inflation. In fact, for more than three decades the published costs of tuition and fees at four-year institutions have risen faster than inflation almost every year. Private four-year colleges have seen published inflation adjusted (real) cost increases averaging 2.8% over that time, while public schools have seen a 3.8% average real increase. In the most recent year, private schools saw a 2.7% inflation-adjusted increase while public schools saw a 1.6% increase.

For the 1986-1987 school year, the average cost of a year's college tuition, fees, and room and board in today's dollars was $8,900 at public schools and $21,650 at private schools. Now, 30 years later, with state funding shrinking, the average costs at public and private schools have more than doubled to $20,090 and $45,370 respectively for the 2016-2017 school year.

It is important to consider that for many students, college expenses go beyond tuition, fees, and room and board. Extracurricular activities—such as sports and the arts—can be enriching but expensive, as can travel and study abroad.

Savings Vehicles

Whether you need to build up assets to finance your children's or grandchildren's education or you expect to be able to pay their education costs out-of-pocket, you may benefit from using one or more savings vehicles. The earlier you begin, the greater the potential benefits.

529 College Savings Plans

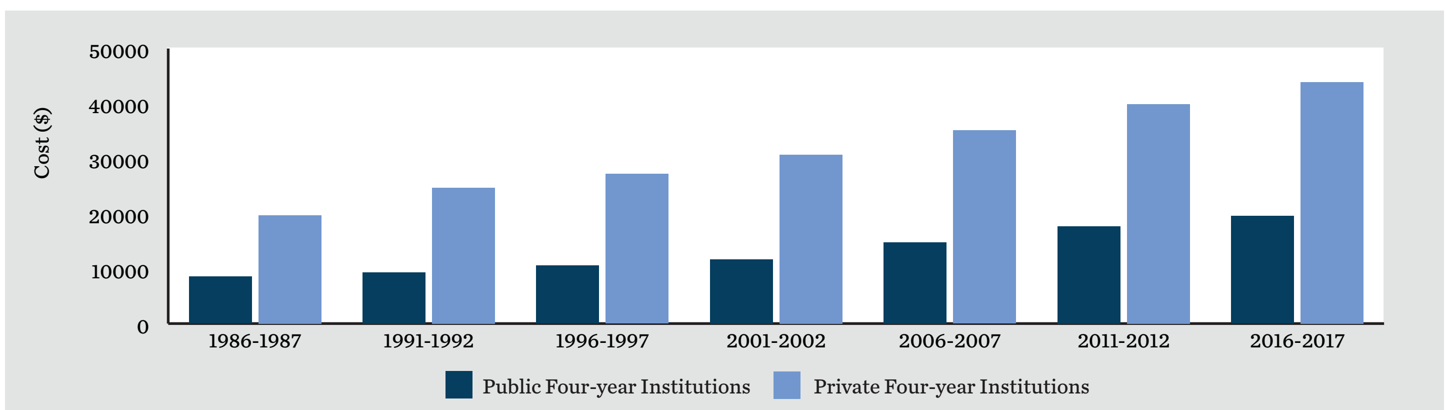
A significant benefit of a 529 college savings plan are the income tax advantages. Contributions are not federally tax deductible, though may be in some states. However, plan assets grow tax-deferred and distributions used for qualified education expenses are not taxable. This means that any growth in the plan is tax-free as long as distributions are used to pay undergraduate and graduate expenses such as tuition, fees, books, and room and board.

This can be particularly valuable if you are in a high-income tax bracket now or expect to pay taxes at a higher rate in the future.

Individual states sponsor 529 plans, and you can contribute to any state's plan. However, you may be eligible for a state income tax deduction for contributing to your own state's plan. Contribution limits are set by the sponsoring state and generally are quite high. You can contribute only cash, not securities. You retain control of the investment account and name the beneficiary. Additional restrictions and limits may apply, depending on the state.

Valuable estate-planning benefits are also available with 529 plans. You can use up to five years of your gift tax annual exclusion (currently $14,000) to front-load the plan. That adds up to a $70,000 immediate contribution—$140,000 for a married couple splitting the gift. The contribution is removed from your taxable estate (although there could be estate tax consequences if you accelerate your annual exclusions and die before five years have passed)—yet

Average Annual Cost of College, 1986-2017



Source: College Board

you still have control over the 529 plan. You cannot make additional annual exclusion gifts to the beneficiary for five years.

You are able to change the beneficiary to certain family members in the same generation, such as a sibling or first cousin of the beneficiary—or even to yourself if you are considering going back to school. This will allow you to avoid taxes and penalties if the initial beneficiary has decided not to pursue a higher education or does not use up all the plan funds on his or her qualified undergraduate and graduate expenses. Beware that changing the beneficiary to someone in a *lower* generation than the current beneficiary, such as his or her child, niece or nephew, could trigger gift and generation-skipping transfer (GST) tax consequences.

A potential disadvantage of a 529 plan is that you must select your investments from the options offered by the plan, and you can reallocate plan assets twice per calendar year. However, most plans offer a range of options varying in style, risk, and time frame. Each time you make a contribution, you can select the investments for that contribution.

Before choosing a 529 plan, compare both the investment options and the fees of several plans. If you are unhappy with your current plan, you can request a tax-free rollover to another 529 plan up to once per 12-month period. Caution: Some states' plans are "recaptured" and included back into taxable income to the extent of prior years deductions.

Another potential drawback to a 529 plan is that any distributions attributable to growth that are not used for qualified education expenses will be subject to income taxes and a 10% penalty.

In addition, 529 plans come in the form of a prepaid tuition plan, which allows you to pay for future tuition at today's prices. The tax treatment is similar to a 529 savings plan. However if the beneficiary decides to go to a school not included in the plan, there may be uncertainty about how the value of the prepaid tuition plan will be determined. Moreover, if the chosen school is private, the value may fall well short of the school's tuition costs. Generally, a prepaid tuition plan covers only tuition, not other major expenses such as room and board.

Uniform Transfers to Minors Accounts (UTMAs)

If you are more concerned about flexibility than about income tax advantages, UTMAs may meet your needs. These custodial accounts allow you to transfer assets that can be used not only for the beneficiary's education expenses, but for any purpose that will benefit the child (except basic support expenses, such as food and clothing).

There is no limit on how much you can transfer to an UTMA, but you will need to consider the gift and GST tax consequences. Transfers to an UTMA are eligible for the annual gift tax exclusion ($14,000, or $28,000 for married couples splitting gifts), and those in excess of your exclusion will use up part of your lifetime gift tax exemption or be subject to gift taxes. If the beneficiary is your grandchild or someone else more than one generation below you, a transfer beyond your annual exclusion generally will also use up some of your GST tax exemption or be subject to GST tax.

Assets transferred to an UTMA are removed from your taxable estate, yet you maintain control over how the assets are invested and distributed until the beneficiary reaches the age of majority (18 or 21, depending on the state). After that point, however, the beneficiary can invest and spend the assets however he or she chooses, which may be a disadvantage.

Another potential downside is the "kiddie tax." It applies to all dependent children under age 19 and also to dependent full-time students under age 24. If the UTMA beneficiary is subject to the tax, any unearned income in the account beyond $2,100 (subject to change) will be taxed on his or her parents' income tax return, likely at a higher marginal rate.

Trusts

Trusts offer another way to transfer an unlimited amount of assets that can be used to fund a child or grandchild's education or other expenses while you maintain some control over investments and distributions. A wide variety of trust options are available, offering various advantages and disadvantages.

An irrevocable trust with a "Crummey provision" is one option that provides a major benefit over an UTMA: The beneficiary does not automatically gain control over the transferred assets after reaching the age of majority.

As with an UTMA, assets transferred to the irrevocable trust are removed from your taxable estate, yet the trustee (someone you name) maintains control over how the

assets are invested and when they are distributed to the beneficiary. The Crummey provision allows you to apply your annual gift tax exclusion when you make gifts to the trust.

One disadvantage of a trust is that it is a complex legal document that must be drafted by an attorney. If the trust is irrevocable, you cannot make changes to it after it has been executed. If the trust has a Crummey provision, the beneficiary will have the right to withdraw a contribution for a limited period after you make it, and he or she must be formally notified of these withdrawal rights, which can make trust administration complex.

In addition, keep in mind that trust income (in non-grantor trusts) that is not distributed will be subject to income taxes—based on special tax brackets for trusts, where the rates climb much more rapidly than for individuals. Trust income distributed to the beneficiary could be subject to the kiddie tax.

Coverdell Education Savings Accounts (ESAs)

If you want to reap the income tax advantages of a 529 savings plan but enjoy more investment control—or finance elementary and high school expenses—you may want to explore a Coverdell ESA.

Similar to IRAs (and once called "education IRAs"), ESAs allow you nearly unlimited investment options and the ability to reallocate assets at almost any time. Similar to 529 plans, distributions used for qualified education expenses are tax free—but for ESA purposes, the definition of these expenses includes not only most undergraduate and graduate expenses but also elementary and high school expenses.

Unfortunately, ESAs have some significant downsides. Perhaps the most significant is the annual contribution limit. It is only $2,000, and that limit is gradually phased out down to $0 based on relatively low income-based limitations.

As a result, an ESA likely will not be sufficient to finance all of your child's or grandchild's education expenses. However, an ESA may be a beneficial supplement to one of the education saving vehicles discussed above.

Direct Tuition Payments

If you would like to avoid the various limitations that apply to the savings vehicles discussed above but still want to help finance your child's or grandchild's education, you likely are better off making tuition payments directly to the school, rather than giving money to the child to pay the tuition. Direct tuition payments are not subject to gift or GST taxes and therefore do not use up any of your annual gift tax exclusion, lifetime gift tax exemption, or GST tax exemption.

This tax-free treatment is available for not just graduate and postgraduate tuition, but also elementary and high school tuition.

Alternative Sources of Funding

Savings vehicles such as 529 plans, UTMAs, and trusts provide valuable ways to build funds for education expenses. But you should not sacrifice saving for your own retirement to save for your child's education expenses. Alternative education-funding sources are available, whereas there are fewer options for funding retirement expenses if you have not built sufficient retirement savings.

Financial Aid and Scholarships

Financial aid comes in a variety of forms, from grants to scholarships to work-study to loans. Often aid is needs-based, but a multitude of merit-based scholarships are also available. In addition, several types of student loans are available regardless of financial need.

Financial aid forms can be complicated, and how need is determined is complex. But remember that the need determination is based partly on the parents' assets and partly on the child's. The impact of education savings on eligibility for financial aid will depend on not only how much you have saved, but also the savings vehicle you have used.

Tax Breaks for Students and Their Families

If you have a child in college or graduate school now, your family may be able to benefit from one of the various tax credits and deductions available for certain education expenses. These breaks generally phase out based on income, but if your income is too high to qualify, your child might be eligible. A deduction for student loan interest is also available; again, however, an income-based phase-out may reduce or eliminate the benefit.

Begin Planning for Education Expenses Today

A wide variety of education financing options are available. A mix of savings vehicles and alternative funding sources might best meet your needs.

The key is to begin incorporating education planning into your overall financial plan as soon as possible. If you start when your children or grandchildren are young, you will have more time to ensure that you have a plan in place that effectively balances your education financing goals with your retirement or estate planning goals. If you are starting later, however, planning becomes even more critical, because you have less time to spare.

Wherever you are on the timeline, begin planning for education expenses today. William Blair has extensive experience with comprehensive financial planning. We can help you determine how education financing should fit in with your overall financial plan and how to best achieve your goals.

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Education Financing Options at a Glance

	ADVANTAGES	DISADVANTAGES	OTHER CONSIDERATIONS
529 Savings plan	• Tax-free earnings and distributions • No income limits for making contributions • Contributions may be deductible for state income tax purposes • Assets generally excluded from owner's estate • Beneficiary can be changed to another family member • Varying levels of control of investments	• Benefit not guaranteed; investment risk • Only for undergraduate and graduate expenses, not primary or secondary education • May only be used for qualified education expenses • 10% penalty and ordinary income tax on the earnings portion of nonqualified distributions	• Need to evaluate different states' plans • Can contribute up to $70,000 once in a five-year period without gift tax ($140,000 for married couples) • Year-round enrollment • Cash contributions only
UTMA (Custodial Account)	• Flexibility—may be used for expenses other than education • No income or contribution limits • Assets excluded from donor's estate • Control of investments	• Beneficiary gains control of assets at age 18 or 21 • No income-tax benefits and may trigger "kiddie tax" • Counts against financial aid application	• May trigger gift tax • Assets owned by the beneficiary
Trust	• Flexibility—may be used for expenses other than education • Control over distributions • No income or contribution limits • Control of investments • If irrevocable, removes assets from donor's estate	• No income-tax benefits • Legal fees to establish	• Attorney creates trust document • May require Crummey provisions to avoid triggering gift tax • May be subject to trust tax rates
Coverdell Education Savings Account (ESA)	• Tax-free earnings and distributions • Kindergarten through graduate expense eligible • Control of investments • Can be rolled over to ESA for another family member	• Benefit not guaranteed; investment risk • Contributions limited to $2,000 per year, phasing out at relatively low income levels • 10% penalty and ordinary income tax on the earnings portion of nonqualified distributions	• All assets must be distributed within 30 days of when the beneficiary turns age 30
Direct payment	• Not subject to gift tax (without using up any annual exclusion or lifetime exemption) • Kindergarten through graduate expense eligible	• Gift-tax-free treatment applies only to payments of tuition and certain fees	• Payments must be made directly to the educational institution

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