THE Wealth REPORT

Student loan debt is growing. 45.3 million Americans carry an average of $37,338 in total student loans for post-secondary education — and the cost continues to rise.[1] Investors who want to help their kids and grandkids avoid this debt have a variety of options available.

THE COST OF COLLEGE

Strategies for paying for higher education

Overview

The cost of post-secondary education has been a hot topic for several years now, especially since student loan repayments resumed in late 2023. College students pay more than $36,000 for one year of college on average, with costs growing by 2% annually over the last decade.[2]

Paying for higher education can be a daunting prospect for many prospective students and their families, especially if they have multiple children who expect to attend college at the same time. While student loans are an option, many people don't want to see their children and grandchildren saddled with student loan debt as they exit school.

Fortunately, there are a variety of investment and savings vehicles designed to help save for college. But first, let's take a look at how much you might need to save.

Calculating Your Costs

College planning professionals say that every student should complete the Free Application for Federal Student Aid (FAFSA®), no matter what their family's economic status.[3] The form is used by the federal government and prospective colleges to assess a student's need for financial aid. The information gathered is used to calculate the family's overall ability to pay via the expected family contribution (EFC). The calculation formula takes into consideration the student's family size and number of dependent children enrolled in college in a given year, as well as a portion of the student's and parents' annual adjusted gross income and assets:

- Parents: 22% to 47% of adjusted gross income[4], plus up to 5.64% of non-retirement assets[5]
- Student: 50% of income over $7,600[4], plus 20% of assets[5]

College Savings Vehicles

It may be a good idea for you to start early and save continuously in an account specifically targeted for college funding. After all, time is typically the investor's friend when it comes to the power of compounding interest. To get started, following is a rundown of some of the most popular college-saving options.

College Savings 529 Plans
A 529 plan is a qualified tuition program with two options:

- **Option 1:** The prepaid tuition plan enables parents to prepay the student's education (in a lump sum or over time) in today's dollars and helps protect against tuition increases. Currently, only nine states offer prepaid tuition plans for new enrollees (Florida, Maryland, Massachusetts, Michigan, Mississippi, Nevada, Pennsylvania, Texas and Washington).[6]

- **Option 2:** The college savings plan invests contributions in a tax-deferred portfolio with an asset allocation matched to the beneficiary's age (automatically rebalanced to lower risk as the student gets closer to college age). Subsequent withdrawals are tax-free when used to pay for the student's qualified expenses at an eligible institution.

Note that the college savings plan can offer more flexibility than a prepaid plan but does not guarantee the investment will yield enough to pay the full tuition costs. Prepaid tuition plans are guaranteed to cover tuition for in-state public colleges only, but some states allow the beneficiary to use the funds at a private or out-of-state school.

Individual states offer 529 plans, and some even allow a portion of contributions to be tax-deductible. However, an investor can open an account in a different state than his or her residence, generally through an investment company. Investment options and account features vary, but all accounts permit high contribution limits and compound tax-deferred, and withdrawals for qualified college expenses are tax-free.

One of the advantages of a 529 savings plan is that it allows the owner (typically a parent or grandparent) to control the account on behalf of the child. The account owner may change the beneficiary to another member of the family and retain the assets if the student doesn't use the money for college. Notably, there is no time or age restriction for the use of 529 funds, and the money may continue growing tax-deferred if the student delays college indefinitely.

Grandparents who open an account to help provide college funding for a family member have the advantage of retaining control of the assets, yet contributions are considered "completed gifts" for the purpose of estate taxes. Any funds not used for qualified college expenses are taxed at ordinary income rates. And starting in 2024, 529 account owners can roll unused assets up to $35,000 into the account beneficiary's Roth IRA without incurring a penalty or generating taxable income, as long as the 529 has been open for at least 15 years.[7]

Coverdell Education Savings Account

A Coverdell account permits owners to pay for a child's educational expenses from grade school to graduate school. Owners can contribute up to $2,000 a year in non-deductible contributions, as long as they fall under required income thresholds.[8]

Like 529 plans, a Coverdell account owner can change the beneficiary to another family member, but any funds that remain in the account after the beneficiary turns age 30 will be subject to penalties.

Traditional and Roth IRAs

Investors who prefer to consolidate their investments may consider using an Individual Retirement Account (IRA) to save for college. Money may be withdrawn to pay for qualified higher education expenses (for the account owner, spouse or child) at any age without being subject to the 10% early withdrawal penalty.[9] However, in 2024, annual contributions are limited to $7,000 ($8,000 if age 50 or over). Distributions from a traditional IRA are taxed as ordinary income.

If the investor uses a Roth IRA for college savings, all contributions are post-tax and money held for at least five years may be withdrawn tax-free.

Investors who use an IRA or Roth IRA generally have more investment options available, and any unused funds may continue to grow tax-deferred for retirement.

Non-Retirement Investment Portfolio

If parents save for college with a taxable portfolio, they may have plenty of investment options available, but the money does not benefit from tax-deferred compounding. When assets are withdrawn to pay for college expenses, gains are taxed at the parents' income rate.

Custodial Accounts

Another option is to establish a "custodial" account for a minor, under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). All funds contributed are considered irrevocable gifts and transfer to the child's control once he or she becomes the age of majority in that state.

In most cases, when the money is withdrawn, the investment gains are taxed at the child's income tax rate, which is usually lower than the parents' rate. However, once the child comes of age, the parent no longer has control over the account, and the beneficiary might not use the funds for higher education as the original account owner intended.[10]

Selecting Your College Savings Vehicle

When deciding which college savings account to choose, you may want to consider how it could impact the student's eligibility for financial aid. A few things to remember:

- Taxable investment portfolios present a greater factor in reducing potential aid than tax-deferred accounts.
- Because a 529 college savings plan is considered a parental asset, it is factored into federal financial aid formulas at a lower rate (5.6%).
- A custodial account is considered the student's asset. Up to 20% may be factored into the calculation, which is more likely to reduce the financial aid package.
- When a grandparent (or someone other than the student or parent) owns the 529 plan, the funds are not factored in as a student asset until distributed. This means that a prior-year withdrawal will count toward the student's income on the next year's FAFSA form — potentially lowering the subsequent aid package.

Final Thoughts

If you or your student plan to attend college, it's important to start saving as early as possible. Our recommendation is to choose the appropriate plan or account for your circumstances and keep investing. Here are a few tips to get started:

- Set up automatic contributions, even if you start with just $25 or $50 a month.
- Increase the amount of your monthly contributions each year.
- Take advantage of employer programs that offer automatic payroll deductions in a 529 plan.
- Pay attention to sales charges and ongoing management and investment fees so that expenses don't substantially reduce returns.
- Add to the account whenever you receive a financial windfall.
- Ask friends and family to contribute to the account as birthday and holiday gifts.

Most importantly, work with a financial advisor to pinpoint which vehicles are right for you and to assist with setting them up. He or she can help you find ways to save for college without putting your current financial situation or future retirement in jeopardy.

The Wealth Report

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