MAKING SENSE OUT OF SAVING FOR COLLEGE

THE FINE PRINT OF AN EDUCATION SAVINGS PLAN

TRANSAMERICA®

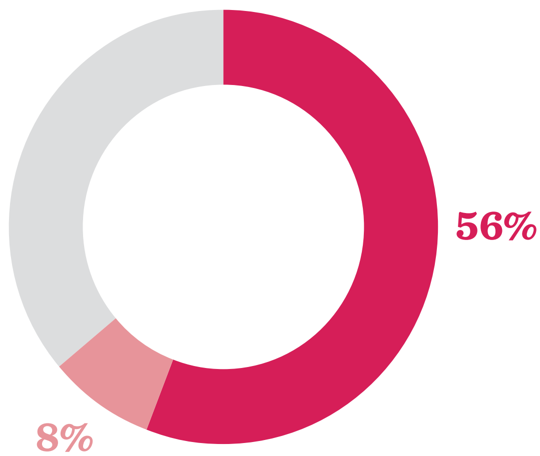
Common Ways to Save for Education

- 529 Savings Plan
- 529 Prepaid College Tuition Plan
- Coverdell Education Savings Accounts
- Roth IRAs
- Traditional Bank Savings Account

Saving for the college education of a child is a very noble goal and many parents would like to help relieve some of the burden student loans create. In 2018, the average student loan borrower graduated with $29,800 in student loan debt.[1]

That's almost the equivalent of a 10% down payment on a $300,000 home. The good news is college savings rates are up. In fact, according to the 2018 national study by Sallie Mae, college savings are the highest they've been since 2013.[2] The average amount parents had saved for their children's education was up to $18,135 in 2018.[2] Also according to Sallie Mae, 56% of parents with a child under the age of 18 who is expected to go to college are saving for it. Another 8% are at least planning for it.[2]

Saving for college may seem as easy as just putting money aside. However, there are several different ways to save for college, and the options can get confusing. This piece gives an overview of some of the common ways to save for education, the pros and cons of each strategy, and explores the financial aid process and common financial aid programs.



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[1] "A Look at the Shocking Student Loan Debt Statistics for 2019," StudentLoanHero.com, updated Feb. 4, 2019

[2] "How America Saves for College: Sallie Mae's National Study of Parents With Children Under Age 18," Sallie Mae and Ipsos Public Affairs, 2018

529 PLANS

A 529 plan, also known as a qualified tuition program, is a tax-favored education savings plan. Gifts to a 529 plan are capped at $15,000 per year, per beneficiary. However, 529 plans have a special rule that allows up to five years' worth of gifts to be made at one time, meaning $75,000 per beneficiary can be contributed at one time but treated as though it was made over five years. (The current year and the next four). Spouses contributing to a 529 account can each contribute the maximum amount, meaning a married couple could contribute up to $150,000. This amount is per beneficiary, so if there are multiple accounts for multiple children, the amount can be multiplied by the number of beneficiaries. Unlike some education savings plans that phase out for higher income individuals, there are also no income limitations for the account owner to make contributions. Anyone, regardless of their income, can contribute to a 529 plan.

$75,000 per beneficiary can be contributed at one time but treated as though it was made over five years.

With a 529 plan, the account owner controls the account. This is usually the parent, not the child. Meaning the child has no rights or access to the account, unlike other types of accounts where the child takes control of the account at some age, such as the age of majority. This can be important in ensuring the money is used for its intended purpose. 529 accounts owned by parents are considered parental assets for financial aid purposes. Money in a 529 plan that is used for qualified education expenses can be withdrawn free of tax or penalty and the beneficiary on the account can be changed at any time for any reason. Common reasons to change the beneficiary are if the child does not need all of the funds in the 529 plan, or they choose not to pursue a post-secondary education.

529 plans come in two varieties: 529 savings plans and 529 prepaid college tuition plans. Currently all states have some form of a 529 plan and 34 states including the District of Columbia that offer a full or partial state income tax deduction or tax credit for contributions. Even though a state income tax deduction may be available in some states, there is no deduction available for 529 plans for federal income taxes.

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WHAT IS A 529 SAVINGS PLAN?

A 529 savings plan is an education savings plan that allows you to save money in a tax-favored manner to pay for K-12 and college tuition costs. Historically, 529 plans could only be used to pay for college expenses. However, starting in 2018, $10,000 per year may be withdrawn free of federal tax and penalty to pay for private, public, or religious elementary and secondary education expenses. Contributions in these accounts grow tax deferred, and funds, including gains, can be withdrawn free of federal tax if used to pay for qualified education expenses. Some states allow qualified withdrawals to be excluded from state income tax as well.

Qualified education expenses include:

1. Tuition and fees
2. Books and materials
3. Room and board as long as the student is enrolled at least half-time (usually at least 6 credits)
    a. For on-campus, limited to the actual cost of room and board
    b. For off-campus, limited to the "cost of attendance" figures that are published by most colleges
4. Computers
5. Internet access

Withdrawals for non-education expenses are subject to a 10% penalty and gains are included in income unless an exception applies. Exceptions to the penalty include:

- Beneficiary receives a tax-free scholarship
- Beneficiary attends U.S. Military Academy
- Beneficiary dies or becomes disabled

Funds can be invested in any number of underlying investments offered by the plan. There is no guarantee of the future value of the account as the funds are invested in the underlying investments and may be subject to market risk. Under current tax law, you can only change investments twice per year.

You do not have to invest in your state's 529 savings plan and funds can be used at any qualifying institution.

WHAT IS A 529 PREPAID COLLEGE TUITION PLAN?

529 prepaid college tuition programs are just as they sound. You prepay for tuition at current rates, but attend at a later date. For example, if you prepay for a semester worth of tuition today at today's rates, it is still worth a semester in the future regardless of what the tuition rates are at that time. Prepaid tuition programs have a guaranteed return on investment, assuming you expect tuition to increase over time. Prepaid tuition programs are a great way to hedge against the rising costs of tuition, however, there is no way to know if tuition increases will outpace possible returns over time in an investment type account, such as a 529 savings plan. Typically, prepaid tuition plans can only be used for tuition and cannot be used for some of the other costs that are allowed from other plans.

It is important to research the details of each prepaid college tuition plan. Many are sponsored by the state and can only be used for in-state public college education. Some plans can be converted for use at private and out-of-state education facilities. Some private colleges may also sponsor their own prepaid tuition plan. Not all states have a prepaid tuition plan and some states have closed their plans to new enrollment.

COVERDELL EDUCATION SAVINGS ACCOUNTS (ESA)

Until recently, Coverdell ESAs were the only education savings accounts that could be used to pay for private elementary or secondary education expenses. With the expansion of qualified expenses from 529 plans, these accounts have become less popular. Contributions grow tax deferred and withdrawals are tax free if used for qualified education expenses. (See the list of qualified education expenses for 529 plans on page 5). Coverdell ESAs have a relatively low contribution limit of $2,000 per year, per child. Also, contributions can only be made until the child turns age 18 and the funds must be used by the time the child turns age 30. Just like a 529 plan, the account holder can change the beneficiary of the account at any time. The ability to contribute is based on income and phases out at $190,000 of Modified Adjusted Gross Income (MAGI) for married couples ($95,000 MAGI for single). These assets are typically considered an asset of the parent or account holder for financial aid purposes. There is a 10% penalty on earnings and earnings are included in the gross income of the account holder if withdrawals are not used for qualified education expenses. The tax deduction allowed in some states for 529 plans does not apply to Coverdell ESAs. Contributions to Coverdell ESAs are not eligible for a state income tax deduction.

Contributions grow tax deferred and withdrawals are tax free if used for qualified education expenses.

ROTH IRAs

Roth IRAs are most commonly looked at as retirement accounts, but can also be used to save for education. Because Roth IRA contributions are made on an after-tax basis, the ordering rules of withdrawals allow the account owner to withdraw regular contributions at any time for any reason, free of tax and IRS penalty. Converted amounts can also be withdrawn free of tax and penalty five years after the conversion took place. The ability to access contributions at any time allows these proceeds to be used for education, or any other purpose. This affords some flexibility to use the contributions for education, if needed, or to leave the proceeds in the account for retirement. There is no penalty for using the funds for any reason beginning at age 59½. In most cases earnings are not available tax and penalty free prior to age 59½, only cumulative contributions. However, investment gain in a Roth IRA can be withdrawn to pay for qualified education expenses free of penalty, but the gain portion will be included in income.

TRADITIONAL BANK SAVINGS ACCOUNT

Many people may think simply opening a savings account for a child is the easiest way to start saving for college. While it may be an easy way to start, it can have some drawbacks. First off, if the account is in the name of the child, it is considered the child's asset. This can count against them when it is time to apply for financial aid. Also, the child would likely have access to it once they reach the age of majority (typically 18 or 21, depending on the state). This means the child will have unrestricted access and can use the money for whatever purpose they see fit, regardless of the original intent for the money. And finally, a bank savings account does not offer any sort of tax benefits for education. It will not receive tax deferral, there are no current tax deductions, and any interest earned in the account will be taxable each and every year. The money, could however, be used free of penalty for any reason, not just for education.

COMPARISON CHART

	529 PREPAID TUITION PLAN	529 SAVINGS PLAN	COVERDELL ESA	ROTH IRA	BANK SAVINGS ACCOUNT
TUITION	Yes	Yes	Yes	Yes	Yes
BOOKS	No	Yes	Yes	Yes	Yes
COMPUTERS	No	Yes	Yes	Yes	Yes
ROOM AND BOARD	No	If enrolled at least part time	Yes	If enrolled at least part time	Yes
ELEMENTARY AND SECONDARY EDUCATION EXPENSES	No	Yes	Yes	Yes	Yes
ANNUAL CONTRIBUTION LIMITS	$75,000 per beneficiary per person (5 year gifting)	$75,000 per beneficiary per person (5 year gifting)	$2,000 per beneficiary	$6,000 per owner ($7,000 if age 50 or older)	None
INCOME PHASE OUT	None	None	$220,000 joint filers $110,000 single filer	$196,000-$206,000 joint filer $124,000-$139,000 single filer	None
STATE INCOME TAX DEDUCTION	State dependent	State dependent	No	No	No

FINANCIAL AID

The Free Application for Federal Student Aid (FAFSA), is the cost-free application to determine whether a student will qualify for financial aid, and to what extent. It also acts as the application for student loan options. With the information from the FAFSA, and several other factors, such as size of family, retirement funds, others assets, and income, an Expected Family Contribution (EFC) can be calculated. This is the amount a family is expected to contribute to a child's education. Based on this amount, it is then determined how much the child is in need of financial aid and what programs may be available.

Some of the more popular programs are Federal Pell Grants, Federal Perkins Loans, Stafford Loans, and Parent Loans for Undergraduate Students (PLUS). The programs can be broken into two groups: needs based and non-needs based.

NEEDS-BASED PROGRAMS:

- Federal Pell Grant
    - In order to be eligible for a Pell Grant there must be a financial need. This is determined by the FAFSA and the EFC. Grants, unlike loans, do not need to be repaid. There is typically a maximum that can be awarded each year.
- Federal Perkins Loan Program
- The amount of a Perkins Loan is determined by the FAFSA and the school because the school is considered to be the lender. Perkins Loans are subsidized loans, meaning the interest that accrues while the student is in school is paid by the federal government. Once the student graduates or drops below part-time enrollment repayment of the loan must begin. The maximum repayment period for a Perkins Loan is 10 years.
- Subsidized Stafford Loans
    - Subsidized Stafford Loans, sometimes referred to as Direct Subsidized Loans, are available to students with a financial need. Like a Perkins Loan, the interest is paid by the federal government while the student is attending. Repayment begins after the student is no longer attending college at least part time. Although there must be a need to qualify for a Subsidized Stafford Loan,
      a wider range of incomes qualify than do for a Perkins Loan.

NON-NEEDS-BASED PROGRAMS:

- Non-subsidized Stafford Loans
    - Non-subsidized Stafford Loans, sometimes referred to as Direct Unsubsidized Loans, are available for any student, regardless of need. The interest on the loan accrues while the student is attending college. The interest can either be paid, or added to the balance of the loan. Even though it is not needs based, a student still needs to fill out the FAFSA to apply. Loan repayment begins when the student is no longer attending college at least part-time.
- Parent Loans for Undergraduate Students (PLUS)
    - PLUS Loans, often referred to as Direct PLUS loans, are loans available to parents to pay for the cost of a child's secondary education. These loans are not needs based, but instead based on the credit worthiness of the parent or parents. Interest will accrue on the loan, but payments do not need to start until the child graduates, drops below part time, or leaves school. Unlike many of the other aid programs, PLUS Loans typically require the parent to apply for the loan on a different application separate from the FAFSA. Repayment of PLUS Loans are the responsibility of the parent and cannot be transferred to the child.

FINAL THOUGHTS

As you can see, preparing for education can be a little daunting, but saving a little bit each month can add up over time. If you're just starting out, determine which options may be available. Consider the following questions:

- Does your income limit the types of account you can use to save for education?
- How much do you want to save?
- Can you leverage accounts like Roth IRAs to supplement education savings?
- Does your state offer a state income tax deduction for certain types of plans?
- How likely is the child to pursue a secondary education?
- Is there another beneficiary if they do not?

If your child is preparing to go school soon, fill out the FAFSA as soon as possible. The FAFSA form is typically available October 1 for the following year's school year. For example, the 2021-2022 FAFSA will be available October 1, 2020. If your child has been accepted to a school and plans to attend, it is generally best to speak with a counselor at that school to help you understand financial aid and loan options available.

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