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Strategies for Funding Higher Education

Like any financial goal, planning in advance can be key

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Key points

- Families need to feel confident their student is getting the right academic experience at the right cost
- The appropriate funding strategy can differ widely depending on student academics, family finances, family benefactor priorities, and unforeseen possibilities
- Parents and grandparents alike have many options to assess when planning for the cost of higher education

As the costs of undergraduate and post-graduate education for some colleges rise, parents are tasked with navigating their own retirement, maintaining their day-to day expenses, along with securing and allocating financial resources to pay for their children's education. Some grandparents also recognize this conundrum and create plans to help their grandchildren achieve these academic goals.

There is an advantage to knowing many of the important questions to ask when starting the college planning process: What is the best savings vehicle for the family? Will this savings impact the student's financial aid eligibility? Can I fund college with gifts I make to my children or grandchildren in trust or outright? Can a grandparent pay tuition directly to a college? What if the student receives a scholarship? What if the child does not attend college?

Identifying the right questions often inspires parents and grandparents to engage with the possibilities that can influence priorities and sequential actions, fostering clarity on which college savings strategies best suit each family. This contemplation is often built around factors connected to tax and estate treatment, control of the account, income restrictions, beneficiary changes, age restrictions, maximum investment amounts, complexity, protection from creditors, impact on financial aid, distribution terms, qualified expenses, flexibility for needs outside of education, contribution limits, student incentives, penalties, investment options, fees, and set-up costs.

With so many variables at play, it often takes an education just to plan for higher education. Efforts to understand this landscape can be paramount to feeling assured that the student is receiving the appropriate academic experience at a reasonable cost. After all, investing in a college education can rank among the largest financial commitments a family makes.

Planning early is key

Like any financial goal, planning in advance can be the key to achieving the desired outcome. Many parents and grandparents begin thinking about college planning at the time of the child's birth, while others put if off until they have built up their financial resources. An early determination of what matters most to the family benefactor and the pros and cons of various investment options can be a quality starting point. These efforts, when communicated between the parent and grandparent generations, can help set a strategy that is best for your family.

What matters most to the donor?

What if a grandparent or parent wants to maintain control of an account designed for education? Or what if the kin supporter wants to create incentives and protections so that the resources are used only for education? Are matters connected to taxes, investment performance, or fees most critical? There are multiple frameworks and lenses to analyze what matters most. There are multiple investment options (trusts, 529 plan accounts, UTMA accounts, and others) that can be more or less aligned with what matters most to the donor. Sometimes exposure and understanding of glass half-full risks are helpful before finalizing a "what matters most" priority list that ideally translates into an aligned savings plan.

Concerns to consider

Of course, the future is difficult to predict; how should parents prepare for unexpected possibilities that involve risks and glasses that are less than full? How many parents know if their young child or grandchild will become drug dependent as a teenager? Who can predict future lawsuits that are placed upon the family? Life always presents levels of unpredictability, and investors and donors should be aware of these improbable (but possible) challenges as they relate to college savings options.

Although very effective for funding education, Uniform Transfers to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) accounts can present concern when certain unfavorable circumstances are presented. More specifically, when a beneficiary reaches an age of maturity under the UTMA and UGMA platform (18 or 21 years old, depending on the account and state of residence), there is essentially nothing the donor can do to prevent the beneficiary from accessing these resources since the gift is irrevocable. The now available funds could potentially be used to further complicate the recipient's life or perpetuate an existing challenge of drug usage. A limited number of states will allow the conversion of the resources from a UTMA to a 2503(c) trust, which could allow for provisions that restrict the resources and incentivize against drug use; but that can only happen if the beneficiary has not reached the age of maturity or if, after the age of maturity, the beneficiary agrees to transfer the account to a trust.

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It can be argued that trusts are a more favorable vehicle to account for the downside of possible drug dependency and mental illness because the family benefactor can restrict or reward the beneficiary specifically on this issue. As an example, a trust can include language that requires drug testing before any resource disbursement, or it can provide a payment upon graduation from a college. Language can be built within the framework of the trust to match the income achieved by the beneficiary and can even control payments that are provided directly to a college (instead of the beneficiary having direct access to the resources). These items can create a safeguard that UTMA and UGMA accounts fail to provide. Family benefactors can also maintain custodial ownership of a 529 plan account, which can also protect against these occasions.

What can happen when there is a disparity of income and assets between grandchildren and parents that significantly favors the grandparents?

Many families seek out both need- and merit-based aid from the colleges. Merit-based aid is based on the child's grades, standardized test scores, and other talents, while need-based aid is computed and awarded on a variety of financial factors that primarily include the income and assets of the parents and child. Because need-based aid is formulaic, there are cases where specific investment options are more detrimentally impactful on need-based financial aid than others.

Assets that are in the name of the child or trust vehicles that are specifically designed (and named) for the child's benefit will have a greater disfavor to the need-based aid possibility than assets that are titled in the name of the parents. Trusts and UTMA/UGMA accounts are among the instruments that will also have a more unfavorable impact on need-based aid probability. Generally, 529 plans, parental general savings deposits, and Coverdell Educational Savings accounts (custodial accounts designed for a beneficiary to pay for educational expenses) are less damaging on need-based aid if the income of the parents does not preclude them from need-based aid consideration. Life insurance is not factored on any of the need-based aid formulas. When need-based aid is calculated by the colleges, the most punitive component of the formula is the income of the parent. The investment vehicle or product connected to assets may be inconsequential in cases where the parental income is already beyond a particular threshold and need-based aid is not a possibility.

Knowing the income thresholds attached to the likelihood of need-based aid can be estimated by utilizing a net price calculator for any specific college. Every college is required to provide a net price calculator, which is traditionally found on the landing page of the school's financial aid section of its website. These calculators will allow the parent to enter family-specific data that includes the income and assets of parents and children (need-based aid), while the more accurate net price calculators will also request information on the child's grades and test scores (merit-aid component) to reveal the estimated net price of the college based on this input. Some parents will use these calculators multiple times to see various estimates based on income and asset hypotheticals and grade and standardized test score variance.

What can happen when there is a need or wish to utilize resources outside of education?

Some investment vehicles are designed specifically with education in mind, and when these resources are used for something other than education, there can be financial consequences. These occurrences are the result of a variety of developments that include children who join the military, beneficiaries who decide not to pursue college at all, students who achieve full scholarships, and everything in between. Instruments like Coverdell and 529 plan accounts will have penalty and tax consequences when withdrawals are used for non-qualified expenses. Even limited purpose trusts like a health and education exclusion trust (HEET) could have taxation consequences if used for a non-qualified expense.

More general trusts (as opposed to a HEET) that have multiple resource uses, beneficiaries, and fluidity of purpose are more ideal than a 529 plan or Coverdell account when resources are pegged for uses other than education. As a consolation, Coverdell and 529 accounts can have beneficiary changes as long as the new beneficiary is related to the original beneficiary.

Understanding 529 college savings plans

The Qualified Tuition Program, under Internal Revenue Service Code Section 529, is one of the most widely used savings vehicles. Put into place over 30 years ago, this program allows taxpayers to contribute to an account or pre-paid tuition program. When used to pay qualified education costs at an accredited college, earnings on these accounts are free from federal and state income tax.

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Figure 1

Education planning: The pros and cons of 529 plans

Pros	Cons
Federal and state tax benefits Investment earnings are excluded from income when used for qualified education expenses. Qualified expenses in each area include IRS-designated higher education expenses; distributions of up to $10,000 annually for primary or secondary tuition at a public, private, or religious school; and $10,000 over a lifetime to pay for principal and/or interest on qualified education loans. Many states also offer tax deductions for contributions made by in-state residents to their own state plan (consult your tax advisor).	**Penalties** A 10% penalty on withdrawals plus income tax on earnings if funds are not used for qualified expenses.
Estate planning advantages Parents and grandparents can utilize their annual exclusion gift and contribute up to $18,000 (2024) each, tax free, every year. May also elect to contribute a five-year lump sum gift* (accelerating annual exclusion gifting) and receive the benefit of additional years of compounding college funds outside of the donor's estate.	**Suitability** Contribution is considered a completed gift utilizing some or all of an individual's annual gift exclusion or lifetime gift. Depending on the family's financial circumstances, the tax benefits of the plan must be weighed against alternative, more sophisticated, planning and gifting strategies.
Investment and distribution oversight The asset is removed from the donor's estate, however, the owner (donor) has control over investments, distributions, and beneficiary designations.	**Investment/Reallocation limitations** Investment options are established by the plan's money manager. Reallocation of existing balances may be limited to only twice per year.
Favorable income and contribution limits No income limitations or phase-outs are imposed on the donor. Plans also have high contribution limits that vary by state (approx. range $235,000 to $550,000) and low minimum investment requirements (as low as $25).	**Contributions are after-tax** While many states offer tax deductions for contributions up to a certain limit, there is no federal income tax deduction for plan contributions.
Favorable financial aid treatment Parent-owned 529 accounts are assessed at a lesser rate on financial aid formulas than accounts owned by children (as an example, more favorably assessed than UTMA accounts).	**Interaction with education tax credits and deductions** Plan withdrawals cannot be used for expenses for which you are claiming an education tax credit or deduction, otherwise the withdrawal will be subject to tax.
Transferable Can be redirected to other family members if original beneficiary has not depleted account. 529 college savings plans generally allow funds to remain in the plan indefinitely.	**Withdrawal requirements on prepaid plans** Prepaid (529) tuition plans generally require all tuition credits to be used before age 30 and all withdrawals be completed within 10 years of the beneficiary starting college.

*If a gift is spread over five years and the contributor dies within the five years, a portion of the gift will be included in the contributor's estate.

Sources: https://www.wsj.com/articles/pros-and-cons-of-529-accounts-for-college-11553450400; https://www.sec.gov/reportspubs/investor-publications/investorpubsintro529htm.html?mod=article_inline

The 2017 Tax Cuts and Jobs Act expanded the definition of "qualified education expense" to include up to $10,000 in yearly distributions for tuition at elementary or secondary public, private, or religious schools, while the 2019 SECURE Act permits a 529 plan beneficiary to take distributions of up to $10,000 over a lifetime to pay for principal and/or interest on qualified education loans. This same Act allows an additional $10,000 (lifetime limit) that may be distributed as a qualified education loan repayment for each of the 529 plan beneficiary's siblings. The Consolidated Appropriations Act of 2023 (Secure 2.0) furthered the potential use of 529 funds by allowing the left over resources within 529 accounts (after a beneficiary's education is complete) to be transferred to a Roth IRA without penalty or tax. For this transaction, 529 accounts must have been opened for fifteen years, are subject to annual Roth IRA contribution limits, and allow an aggregated maximum amount of $35,000 for this transfer. If the owner changes the beneficiary on a 529 account, this modification will re-start the fifteen-year timetable requirement. In addition to the tax-advantaged savings, some state plans offer their residents income tax deductions or credits on contributions. Unlike other tax-advantaged savings vehicles, there is no income limitation or phase-out for individuals who decide to contribute to this type of plan. Account owners are typically a parent or grandparent (although parties are not required to be related) and the beneficiary is the future student. The account owner maintains control over the 529 account, including the ability to change beneficiaries without penalty, provided the new beneficiary is related to the prior beneficiary. The contribution is considered a completed gift and is excluded from the contributor's estate.

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Contributions to the 529 plan qualify for the annual gift tax exclusion, which is currently $18,000 per recipient; however, there is one unique exception to this limit for qualified tuition plans. The account owner can elect to make contributions larger than the annual gift exclusion (up to five years of annual gifting) without gift tax consequences, provided no other gifts are made to the beneficiary that would be considered annual gifting. These larger gifts to a 529 plan, often referred to as "super funding," allow married couples to contribute $180,000 ($90,000 for a single filer) to a 529 plan at one instance rather than over a five-year period. Since the gift is accelerated, an IRS Form 709 must be filed at the end of the year as part of the transaction.

In many cases, the 529 plan is a quality savings vehicle for college; however, the benefits must be weighed against the drawbacks (see Figure 1). For example, for high-net-worth families, the account owner must weigh the tax benefits of gifting to a 529 plan against alternative, more sophisticated wealth transfer planning and gifting strategies.

On certain occasions, questions arise when resources have been accumulated in a 529 plan and the student is awarded a scholarship, or when the student enters a college on an ROTC scholarship with a stipend. With regard to 529 plans, money in the amount of the scholarship can be withdrawn without a penalty, but tax will be paid on the earnings. Individuals are urged to consult with their tax advisors on any potential state income tax ramifications when using 529 plan distributions for K-12 tuition, paying off educational loans, or for non-qualified withdrawals.

What can happen when market conditions are highly volatile?

There are certain investment vehicles that are more flexible and adaptable to the frequent need for asset class reallocations than others. Among the more restrictive investment possibilities when faced with a need to consistently reallocate are the above-referenced 529 plan accounts since they only allow for two asset reallocations per year. Most other avenues of investment are not as restrictive. In addition, when compared to other investment options and structures, 529 plan accounts have an abridged set of investment possibilities, even when an investor is preparing to reallocate.

With all of these cautions and possibilities in mind, a donor can create a priority list of what matters. Based on this, a donor can connect with his or her investment professional to best align this list with the various investment vehicles.

What can happen if an account owner, donor, or beneficiary is legally sued or if an account is placed with a spouse after divorce?

Very rarely does anyone welcome the thought of a lawsuit as a defendant or tortfeasor. When lawsuits transpire, resources dedicated to funding education could be vulnerable to the legal outcome depending on how those resources are structured and invested. One of the fundamental tenants of any trust is the protection from creditors and the maintenance of the donor's intentions. Trusts can also protect intentions in moments of divorce when assets are divided. Other methods of college savings are more open to possible dispossession during lost litigation, and the levels of protection will vary by state and by type of investment.

Gifting considerations

Another option for grandparents to consider is an outright gift of cash. However, any gifts that exceed the annual gift exclusion may have gift tax and generation-skipping transfer tax consequences. This gift will also be considered untaxed income for the student for financial aid purposes. An alternative consideration is a tuition payment directly to the educational institution. While the payment could reduce need-based financial aid entitlement if made directly to the college, the tuition payment is not considered a gift and can exceed the annual gift exclusion without gift tax consequences. Direct payments to the institution or proceeds derived from a 529 plan not only provide the satisfaction attached to providing education, but these assets are also removed from the estate, potentially reducing estate tax for the wealthy individual or couple.

Education is often viewed as one way to continue and protect a family's legacy. Conversely, it takes an education to properly plan for the appropriate college savings strategy.

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As part of the Wilmington Trust Emerald Family Office & Advisory® team, Jerry creates and facilitates customized family workshops for family members seeking engagement and preparation for the present and future roles within their families. These workshops are designed to assist families with communication, personal legacy planning, wealth transition, and financial education.

Additionally, Jerry provides research-based information for Wilmington Trust's clients on the many financial and non-financial choices and paths available during the education selection process. The educational roadmaps provided by Jerry to parents, grandparents, and students help to establish a sound educational foundation for young adults as they transition from scholarly students to productive members of the world of work and citizenry. Jerry has more than 18 years of banking and finance experience and is a Certified Financial Therapist-Level I™ Practitioner (CFT-I). He holds an EdD in educational leadership and administration from D'Youville College; two master's degrees from SUNY Buffalo in urban policy and school counseling; and a bachelor's degree as a University Scholar from Xavier University.