Ascension Capital

Everything You Need to Know About College Savings Plans

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The cost of attending a four-year college in the United States is high, but the financial benefit of a bachelor's degree arguably outweighs the cost. According to data from the Federal Reserve Bank of New York, a high school graduate between the age of 22 and 27 makes a median annual wage of $30,000, while a full-time worker with a bachelor's degree brings in $52,000.

This is the largest gap between the two categories in 30+ years of record-keeping, and it seems poised to continue growing. Over a lifetime, the difference in earnings amounts to greater than $800,000[i], which can easily compound into millions with a smart saving and investment strategy. The return on investment (ROI) for a college degree is often high, but it's also a life-changing experience most parents and grandparents want for their children.

That said, attending college is not cheap – the national average for in-state annual tuition for a public university was $10,740 in 2021-2022, rising to $27,560 for out-of-state residents. If we add-in the cost of books, room and board, and other expenses, the cost can easily top $40,000 a year[ii].

Fortunately, families have several options to prepare for the financial cost of higher education, and many of them offer tax breaks and benefits that are worth taking advantage of. We review these options below, and encourage you to reach out to us directly if you want to learn more or want us to help you set up a college savings plan.

529 Plans

WHAT IT IS

529 plans are legally known as “qualified tuition plans.” They are tax-advantaged vehicles designed to encourage saving and investing for future college education expenses. There are two types of 529 plans: prepaid tuition plans (see Texas Tuition Promise Fund below) and education savings plans.

In our view, education savings plans are the most attractive type of 529 account, as they allow investors to allocate dollars to tuition, books, room and board, and more, at basically any university. These plans also allow people to invest the money saved, which means generating compound interest over time. There is also plenty of choice – every state in the US sponsors a 529 plan, and investors are free to shop across state lines to find a plan that has attractive investment options at low costs.

Texas’s two education savings plans are the Texas College Savings Plan and the LoneStar 529 Plan.

PROS

+ **The most significant benefit of 529 education savings plans is the tax treatment. Contributions are generally made with after-tax dollars (though some states offer tax breaks), but investment growth is tax-free and withdrawals made for qualifying education expenses also do not trigger a taxable event. From a tax perspective, 529s are basically structured like Roth IRAs, only they are for education instead of retirement.**

+ **Another attractive feature of 529 education savings plans is that there is no set cap on how much you can contribute each year. The IRS says “contributions cannot exceed the amount necessary to provide for the qualified education expenses of the beneficiary,” but there is not set number limit. Most states cap contributions between $235,000 and $529,000, which is of course very high. On the estate planning front, the IRS allows a person** to accelerate 5 years' worth of the annual gift exclusion, or $80,000, per beneficiary as a contribution to a 529 plan. These large contributions can reduce the value of one's estate.

+ Finally, there is quite a bit of flexibility within 529 plans. Every state offers a plan, and you do not necessarily need to use your own state's plan. What's more, if the beneficiary of the 529 plan decides not to attend college, you can simply change the beneficiary to another person without triggering any tax consequences. You could also use 529 funds towards $10,000 of tuition for private or religious elementary, middle, and high school.

CONS

- For education savings plans, one negative is that any funds used outside of the "qualified education expenses" category will be subject to a 10% penalty and ordinary income taxes. In other words, the money is locked-into being used for education, unless you want to pay the penalty.
- Another negative is for prepaid tuition plans, since those 529 plans are designed to prepay for higher education at one of your home state's public universities. If your child or grandchild decides to attend elsewhere, the credits can be transferred, but not necessarily for the same value.

Texas Tuition Promise Fund

WHAT IT IS

The Texas Tuition Promise Fund is an example of a prepaid tuition plan for the state of Texas. The idea here is that a family can lock-in today's prices for tuition at one of Texas's two- or four-year public colleges and universities.

PROS

- With tuition costs generally rising at a faster pace than broad-based inflation, locking-in today's tuition rates can mean saving tens of thousands of dollars.
- Also, there is some flexibility to apply the "transfer value" of the prepaid tuition to medical/dental schools, private universities or out-of-state universities, or registered career and apprenticeship programs.

CONS

- Your child or grandchild may decide to attend a school outside of Texas, or may choose not to attend college at all. In either of these cases, some of the value of the prepaid tuition will be lost.

Coverdell Education Savings Account

WHAT IT IS

Coverdell Education Savings Accounts (ESAs) were formerly known as "education IRAs," and they are trust or custodial accounts that can be used for education expenses essentially of any type – from primary school to a master's degree.

Coverdell ESAs must be established for a beneficiary under the age of 18.

PROS

- The earnings in a Coverdell ESA grow tax-deferred, and withdrawals made for qualified education expenses are tax-free.

CONS

- Although there is no limit to the number of Coverdell ESAs that can be established for a beneficiary, the maximum annual contribution that can be made is $2,000. There are also income limits for who can contribute to a Coverdell ESA, which phases out at $220,000 for joint filers. The exception here, however, is that corporations and trusts are not subject to income limits, and can therefore contribute to Coverdell ESAs with no restrictions.
- With a $2,000 maximum annual contribution limit, however, these vehicles are not very effective in the current education landscape.

Taxable Brokerage Accounts

WHAT IT IS

An investor may choose to save for college or education related expenses using an account without tax benefits but also without restrictions for how the money is used. Taxable brokerage accounts would be a good option for this approach.

PROS

+ Investors would have full control over the investments in the brokerage account, and the money can be used for non-education expenses with no penalty or additional tax consequences. If someone's child or grandchild decides to start a business instead of attending college, for instance, money from the taxable brokerage account could be 'seed capital' to help get the business off the ground.

CONS

- Realized gains in the taxable brokerage account would be taxed at capital gains rates, which could change from administration to administration. Missing out on tax-deferred investment growth could be meaningful over time.

Custodial Account

WHAT IT IS

A custodial account is a brokerage account that an adult sets up for the benefit of a minor. While the minor is still under adult age (18 or 21 depending on the state), the account holder (you) controls all aspects of the account. When the minor turns 18 or 21, they would take full control of the account.

PROS

+ An account holder maintains control of the account, selecting investments and managing the funds. Custodial accounts can also be funded with gifts, which in 2022 amount to $16,000 ($32,000 for a couple) per recipient[iii]. Custodial accounts can be a great way to introduce a minor to saving and investing, while also sending them into adulthood with some capital.
+ If money in the account is used for the benefit of the minor, it can be withdrawn without penalty.

CONS

- Much like a taxable brokerage account, there are no tax benefits to custodial accounts. Realized gains are subject to capital gains taxes.

CONS

- A custodian also loses access to the account when the minor becomes a legal adult, and there is of course the possibility that the newly designated adult is not quite ready to have access to that much money. Another con is that once a custodial account is set up, it cannot be revoked – the assets immediately become property of the child.

Trust With HEMS Clause

WHAT IT IS

A final option for saving for college is to set up a trust with a "HEMS" clause, which stands for "health, education, maintenance, or support." Placing a HEMS clause on a trust will allow the trustee to disperse funds for those specific purposes, once the trustee establishes that the request is legitimately for one of those four categories.

PROS

+ The HEMS clause can ensure that funds in the trust are spent for very specific reasons, which can eliminate the possibility over whether funds are being used wisely or for legitimate needs. It also removes ambiguity for the trustee as to how the assets should be allocated.

CONS

- If the trust's HEMS clause specifies what types of education, health, maintenance, or support expenses are acceptable, there could be confusion if a related expense falls slightly outside of the set standards. There is also

Conclusion

There are many different ways to set aside money for higher education, but in our view, 529 plans are the most tax-efficient and optimal investment vehicles available. 529 plans have flexibility, attractive tax treatment, high contribution possibilities, and in many cases great investment options. The team at Ascension Capital can help you sort through your options if this is route your family decides to take, and we can help choose the plan that works best for you.

The ability to save for college is not just limited to 529 plans, however, and any of the options detailed in this letter can be utilized. We can help you determine if the rules, conditions, and tax benefits of a specific option work better within your family's financial plan.

One final consideration as you think about sending your children or grandchildren to college—be sure your living will and other aspects of your estate plan are complete and updated. As future generations of your family embark on building their own lives, careers, and families, it can give everyone peace of mind – and also offer the greatest chance of success – if the estate plan is firmly in place.

Sources:

[i]Source: Federal Reserve Bank of New York
[ii]Source: CollegeBoard
[iii]Source: Internal Revenue Service