# College Savings Options

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Nearly 60% of current college students are worried about paying for tuition and other school related expenses (National Student Financial Wellness Study Key Findings Report, 2014). The college savings options outlined in this document may be useful for you or someone you care about for future college expenditures to help alleviate or eliminate the financial stress many current college students face.

There are several savings options you have when you decide you are going to start saving for college. You could set aside money in a savings account or regular brokerage account. Alternatively, you could take advantage of accounts with financial advantages built into them if they are used for college expenses. Two savings plans designed to be used for college expenses are 529 plans and Coverdell Education Saving Accounts. There are two types of 529 plans, and every state has at least one. The two types are prepaid tuition plans and savings plans.

## 529 Prepaid Tuition Plan

A 529 prepaid tuition plan allows you to pay for tuition at slightly more than today's tuition rate to use at some point in the future. For example, if your state has prepaid 529 plans, and the college you are interested in is an eligible college with current tuition of $5,000 per semester, you could purchase one semester's worth of tuition for a little more than $5,000. Then, the beneficiary of this plan could attend this college in the future with one semester paid for regardless of what the tuition expense is at that time. Almost no prepaid 529 plans cover expenses beyond tuition, such as room and board and other necessary school related items.

Contribution limits vary by state and age of the beneficiary, but typically range between $50,000 and $100,000.

What happens if your beneficiary decides not to attend college, or decides to attend a different college? Most state plans will pay the tuition expenses for another qualified college up to the amount that would have been paid to attend the original chosen college. If your beneficiary decides not to attend college, attends a college not covered by the prepaid plan, or has a scholarship that would pay for tuition, most prepaid plans allow you to transfer the plan to a family member of the beneficiary. The final option is to cancel the prepaid plan. If you cancel the plan you will likely only get back what you paid into the plan, not the appreciated value of the prepaid tuition at the time of cancellation.

## 529 Savings Plan

A 529 savings plan, similar to a 401(k) or 403(b) retirement plan, is an investment account where you choose among mutual fund options. The value of your 529 savings plan is determined by the return on your selected funds and it could gain or lose value. This differs from the prepaid plan that takes market volatility out of the equation. In addition to tuition, funds in the savings plan can be used for other college related expenses such as books and supplies as well as room and board. This can be an added benefit compared to the prepaid plans. Most states allow a low initial contribution – as low as $250 – to open an account. Subsequent contribution amounts may be as little as $50 in many states. Contribution limits currently range from $235,000 to $400,000.

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## Choosing Between 529 Plans

Which type of 529 is best for you? First, check to see if a prepaid plan is even an option for you. While 17 states offer 529 prepaid tuition plans, not all of them are open to new enrollees. In addition, not all colleges are covered by 529 prepaid plans even if this option is available in your state. Further, with 529 prepaid tuition plans, most states have residency requirements that either you or your beneficiary be a resident of that state when you open the account. This residency requirement does not exist for the 529 savings plan. For instance, with the 529 savings plan, you can live in Virginia, the beneficiary can be living in Iowa, you can contribute to a plan in New Hampshire, and the beneficiary can attend college in California. However, in all but six states, you would need to use the 529 plan from your state of residence in order to get a state income tax break. Neither type of 529 plan results in taxes on the appreciation of the value of your account when the funds are used for qualified education expenses.

## Coverdell Education Saving Account

Another college savings option is a Coverdell Education Saving Account (ESA). This account is similar to the 529 savings plan but has a few advantages and disadvantages. An advantage to an ESA is that there are more investment options. [The only restriction for an ESA is that it cannot be used to purchase life insurance.] Another advantage is that an ESA may be set up at most financial institutions. In contrast, each state only has a few financial institutions they allow to manage 529 plans. Finally, an ESA may be used to fund private elementary school and high school expenses, whereas a 529 plan can only be used only for post-secondary education. A disadvantage of an ESA is that no more than $2,000 may be contributed to an ESA beneficiary in any given year, assuming one meets the income limitations (Marginal Adjusted Gross Income of $110,000 for single and $220,000 for joint filing status in 2016).

## Individual Retirement Accounts

A final option is actually an account designed to be used for retirement savings. Roth and Traditional IRAs allow for penalty free withdrawals if used for qualified education expenses including tuition, fees, books, supplies, and room and board if enrolled at least half-time. Annual contributions are limited by the lesser of one's earned income or $5,500 in 2016 ($6,500 if over age 50). Further, if you withdraw only the contributions from your Roth IRA, you will pay no income tax. However, if it is prior to the age 59 ½ any withdrawal gains from your Roth IRA or any amount from your Traditional IRA there will be normal income tax on the withdrawal. Basically, using your IRA to fund a qualifying education expense eliminates the 10% early distribution penalty.

## Summary

Ultimately, the account you choose to fund secondary education is a personal decision. Each account has its own advantages and disadvantages. The important thing is to start saving early as small amounts can add up over time. More saving now may mean less borrowing for you or your loved one in the future. A summary table of all college savings options can be found on the next page.

## Resources

*National Student Financial Wellness Study Key Findings Report (2014).* The Ohio State University. http://cfw.osu.edu/posts/documents/nsfws-key-findings-report-2.pdf

Smart Saving for College – Better Buy Degrees
http://www.finra.org/file/smart-saving-college

State Section 529 Plans
http://www.finaid.org/savings/state529plans.phtml

# College Savings Comparison Table

| | Brokerage | 529: Prepaid | 529: Savings | Coverdell ESA | IRA |
|---|---|---|---|---|---|
| **Summary** | Normal investment account offering no special tax treatment for education expenses. | State sponsored plan that keeps pace with the increase in cost of college tuition | State sponsored investment account. Similar to a brokerage account but with investment limitations and tax breaks | Investment account similar to a brokerage account but with tax breaks when withdrawals spend on education | Retirement account that when used for qualified college expenses will avoid a 10% penalty |
| **Contribution Limit** | None | Typically between $50,000 and $100,000 | Ranges from $235,000 to $400,000 | $2,000 per year and must be made before beneficiary turns 18 | $5,500 per year ($6,500 if 50 years old or older |
| **Qualified Expenses** | Not applicable | Tuition at a college within the state's plan | Tuition, fees, and if at least enrolled half time - room and board | Can fund private elementary and high school expenses in addition to college tuition, fees, books, supplies, equipment, and if enrolled at least half time - room and board. | Tuition, fees, books, supplies, equipment, and if at least half time enrolled -room and board. |
| **Tax Benefits** | None. Gains from investment held less than one year is taxed at normal income tax rate. Investments held longer than a year are taxed at either 0%, 15%, or 20% depending on income level | Contributions may be partially, fully, or not deductible at all depending upon the state (state taxes only). Earnings grow tax free. Qualified education expense disbursements are tax free. | Contributions may be partially, fully, or not deductible at all depending upon the state (state taxes only). Earnings grow tax free. Qualified education expense disbursements are tax free. | Earnings grow tax free and qualified education expense disbursements are tax free. | If taken after age 59 ½ no tax on Roth IRA. |
| **Transfer Options** | Not applicable | Can be transferred to another immediate family member. | Can be transferred to another immediate family member. | Can be transferred to another immediate family member if the new beneficiary is under age 30. | Not applicable |
| **Penalty for Non-qualified Withdrawal** | Not applicable | Taxed as ordinary income to contributor, plus a 10% penalty. | Taxed as ordinary income to contributor, plus a 10% penalty. | Taxed as ordinary income to contributor, plus a 10% penalty. | Taxed as ordinary income to contributor, plus a 10% penalty. If withdrawals are taken after the age 59 ½. |



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