Research Paper

Education Savings Options – An Overview

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3. The content herein was developed from sources believed to be providing accurate information.
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5. All final investment and planning decisions are at the discretion of the client.

INTRODUCTION

This research paper is intended to provide the reader with introductory information related to savings and investment options for education purposes. We start by summarizing the current cost of higher education and identifying factors to consider when assessing education funding options. We will then define the common Education Savings options, summarize each option's advantages and disadvantages, and list resources for further investigation.

No option is perfect. Some will offer tax advantages but will impose restrictions on how the accumulated funds are used, and by whom. Others may offer broad flexibility in the use of the accumulated funds but will not offer tax advantages. For many people saving for education, a combination of the options presented may be the best approach.

One factor that will benefit any option selected is to start saving for a child's education as soon as possible, to take advantage of more regular contributions and the compounding effect on earnings over time. Our article at https://www.eustaceadvisors.com/blog/advantage-time-investor showcases the advantage gained by starting to save for any long-term goal as early as possible.

ESTIMATED COSTS OF HIGHER EDUCATION

The cost of attendance (COA) refers to the total cost of tuition and fees, books and supplies, as well as room and board for those students living on campus. COA does not include transportation costs, daily living expenses, student loan interest, etc. There are many reports and surveys offering data related to the cost of higher education – we selected the report below, as the data is up-to-date.

The costs cited below are for the 2021-2022 academic year.

- Between 2001 and 2020, the average cost of tuition at 4-year public institutions rose by 5% a year, much greater than the general rate of inflation. At many private institutions, the cost of tuition rose at a rate >5%.
- At public 2-year community colleges, in-district tuition and fees average $3,970 annually. Many attendees opt to commute to these institutions, so room & board and other daily expenses will be lower than for students living on campus.
- COA for an in-state student living on campus at a public 4-year university is $26,027 per year or $104,108 over 4 years. The average cost of tuition and fees at these institutions is $9,678 per year.
- COA for a student attending a private, nonprofit university is $55,840 per year or $223,360 over 4 years. The average cost of tuition and fees at these institutions is $38,768 per year.
- While 4 years is the traditional period to earn a bachelor's degree, just 40.4% of bachelor's degree-seeking students graduate within that time.

Source: Hanson, Melanie. "Average Cost of College & Tuition" EducationData.org, November 18, 2023, https://educationdata.org/average-cost-of-college"

FACTORS TO CONSIDER

Many of the factors cited below will not be known for certain when education savings plans are initially defined, ideally while the child is young. However, these factors may steer the family towards a particular type of education savings option.

1. Based on our current budget, how much can we afford to save each month?
2. What is the likelihood that the child will attend college/university?
3. What is the timeline until education costs begin, to account for projected cost increases?
4. What is the projected duration of higher education? As noted above, <50% of college students complete their degrees within 4 years.
5. What is the likelihood that the child will attend public or private university?
6. Is there a potential for the child to complete one or two years at a community college before going to a 4-year institution?
7. Is it likely the child may earn a scholarship, or leverage military or similar education reimbursement programs?
8. Are there multiple children or family members that may require education funding?
9. What is the impact on potential financial aid of the savings plan being considered?
10. What are our options for the accumulated assets in a given education savings option if the child does NOT attend college/university?

TYPES OF PLANS TO SAVE FOR EDUCATION EXPENSES

There are numerous popular education savings options, including:

1. 529 Plans: These are tax-advantaged savings plans operated by states or educational institutions. They allow you to save and invest money for qualified higher education expenses. The earnings in 529 plans grow tax-free, and withdrawals for qualified expenses are also tax-free.
2. Coverdell Education Savings Accounts (ESAs): Coverdell ESAs are another tax-advantaged option that allows you to save for education expenses. Contributions are not tax-deductible, but the earnings grow tax-free, and withdrawals for qualified education expenses are also tax-free.
3. Uniform Gift to Minors Act/Uniform Transfer to Minors Act (UGMA/UTMA) accounts: These accounts allow you to transfer assets to a minor, who gains control of the account once they reach the age of majority (typically 18 or 21, depending on the state). Although gift tax limits may apply, there are no contribution limits with these accounts. Earnings in these accounts may be subject to taxes if they exceed a certain amount.
4. Roth IRAs: Although primarily designed for retirement savings, Roth IRAs offer some flexibility. Contributions can be withdrawn without penalty and tax-free at any time and may be used for education expenses. However, it is important to prioritize retirement savings in Roth IRAs, whenever possible.
5. Taxable Savings and Investments
    a. Bank accounts, CDs and Savings Bonds: Traditional savings accounts, certificates of deposit (CDs), and savings bonds are simple and accessible options. While they do not offer the same tax advantages as the previously mentioned options, they provide a low-risk way to save for college expenses.
    b. Mutual funds, ETFs and other investments: Investing in mutual funds or ETFs can provide higher potential returns but also involves more risk. They do not offer the tax advantages of dedicated college savings accounts, but also have no restrictions on when and how the accumulated funds are used.

529 PLANS

A 529 plan is considered an excellent option for education savings due to its tax advantages and flexibility in covering a wide range of educational expenses. There are two main types of 529 plans, the Education Savings Plan and the Prepaid Tuition Plan, which have significant differences.

529 Education Savings Plans

Of the two types of 529 Plans, 529 savings plans are more common. Contributions to the plan are invested in a selection of investment options (usually mutual funds), typically at the discretion of the account owner. Withdrawals from a 529 savings plan can be used for college and K–12 qualified expenses. Qualified expenses include tuition, fees, room and board, and related costs. Recent regulatory updates expanded the allowable use of tax-free 529 plan withdrawals to include registered apprenticeship program expenses and up to $10,000 in student loan debt repayment for account beneficiaries and their siblings, and to permit rolling over up to $35,000 of unspent funds in a 529 account into a Roth IRA account.

529 Prepaid Tuition Plans

Prepaid tuition plans are offered by a few states and some higher education institutions. Typically, these plans allow the owner to lock in tuition at current rates for a student who may not be attending college for years to come. Prepaid plans are not available for K–12 education.

As with 529 savings plans, prepaid tuition plans grow in value over time. Eventual withdrawals from the account used to pay tuition are not taxable. However, unlike 529 savings plans, prepaid tuition plans do not cover the costs of room and board.

Prepaid tuition plans may place a limit on which colleges they may be used for. By contrast, the money in a 529 savings plan can be used at almost any eligible institution. In addition, the money paid into a prepaid tuition plan isn't guaranteed by the federal government and may not be guaranteed by some states.

Here are some key benefits and potential drawbacks of the 529 Savings Plan to consider:

Pros:

1. Tax Advantages:
    a. Tax-Free Growth: Earnings in a 529 plan grow tax-free.
    b. Tax-Free Withdrawals: Withdrawals for qualified education expenses are tax-free.
2. State Tax Benefits: Many states offer tax deductions or credits for contributions to their 529 plans, providing additional savings on state income taxes.
3. High Contribution Limits: 529 plans typically have high lifetime contribution limits, often exceeding $300,000 per beneficiary, depending on the state.
4. No income limit on contributors. Contributions can be made by anyone, regardless of their income.
5. Flexibility in Use: Funds can be used for a wide range of education-related expenses, including tuition, fees, books, supplies, and sometimes room and board. Recent changes have also allowed 529 funds to be used for K-12 tuition (up to $10,000 per year) and certain apprenticeship programs.

6. Minimal Impact on Financial Aid: 529 plans are considered assets of the parent (if the parent is the account owner), which has a smaller impact on financial aid eligibility compared to assets owned by the student.
7. Transferability: If the beneficiary does not use the funds, the account owner can change the beneficiary to another qualifying family member without penalties.

Cons:

1. Penalties for Non-Qualified Withdrawals: Withdrawals for non-qualified expenses are subject to income tax and a 10% penalty on the earnings portion.
2. Investment Choices: Investment options in 529 plans are typically limited to the options offered by the plan, which may not be as broad as those available in other investment accounts.
3. Fees and Expenses: Some 529 plans may have higher fees and expenses than other savings and investment account types, which can impact the overall returns. It is important to compare 529 plans and choose one with low fees and good investment options.

TAX TREATMENT OF 529 PLANS

529 plans are tax-advantaged education savings plans in the United States that are designed to encourage individuals to save for future education expenses. The tax treatment of 529 plans varies depending on the specific type of plan and the state in which it is established. Here are some general guidelines regarding the federal tax treatment of 529 plans:

Tax-Deferred Growth: Contributions made to a 529 plan are not deductible from federal income taxes, but the earnings on the contributions grow tax-deferred. This means that you do not have to pay taxes on the investment gains as long as the funds remain in the plan.

Tax-Free Withdrawals: If the funds from a 529 plan are used for qualified education expenses, such as tuition, fees, books, supplies, and certain room and board costs, the withdrawals are typically tax-free at the federal level. This applies to both the principal amount contributed and the investment gains.

Non-Qualified Withdrawals: If you make a non-qualified withdrawal, meaning you use the funds for expenses that do not meet the IRS definition of qualified education expenses, you may be subject to federal income taxes and a 10% penalty on the earnings portion of the withdrawal. The principal amount you contributed is not subject to the penalty, but the earnings portion is.

State Tax Benefits: In addition to federal tax benefits, many states also offer tax incentives for 529 plan contributions. These incentives may include deductions or credits for contributions made to the plan, as well as tax-free withdrawals for qualified education expenses. The specific tax benefits vary by state, so it is important to check the rules for the state in which the 529 plan is established.

Gift Tax Considerations: Contributions to a 529 plan are considered gifts for federal tax purposes. You can contribute up to $18,000 per year per beneficiary without incurring federal gift tax (as of 2023). Additionally, a special "superfunding" provision allows you to contribute up to $90,000 (or $180,000 for married couples) per beneficiary in a single year, spreading the gift over five years for tax purposes.

WHAT HAPPENS IF THE 529 BENEFICIARY DOESN'T USE THE 529 ASSETS?

If you have leftover funds in a 529 plan, such as when the beneficiary receives a significant scholarship or chooses not to go to college, you have several options.

1. You can change the beneficiary to another qualifying relative,
2. Keep account in place with the current beneficiary in case they decide to pursue higher education later or attend graduate school,
3. Use up to $10,000 to repay the original beneficiary's or their siblings' federal or private student loans, or
4. Transfer unused funds to a Roth IRA for the beneficiary if the account meets the necessary requirements.

If none of these options are practical, you can withdraw the money from the 529 account, although you will be subject to taxes and a 10% penalty on the earnings portion of the withdrawal.

529 Summary:

A 529 plan is often one of the best options for education savings due to its tax benefits, high contribution limits, and flexibility. It allows you to save specifically for education expenses while potentially receiving state tax incentives. However, it is important to consider your individual circumstances and goals, and to compare 529 plans to find one with low fees and good investment options.

COVERDELL SAVINGS ACCOUNTS

A Coverdell Education Savings Account (ESA) is a type of tax-advantaged account designed to help individuals save for qualified education expenses. Here are some pros and cons of a Coverdell ESA:

Pros:

1. Tax advantages: Contributions made to a Coverdell ESA are not tax-deductible, but the earnings grow tax-free, and qualified withdrawals are also tax-free. This can provide significant tax benefits over time.
2. Flexible use of funds: The funds in a Coverdell ESA can be used to pay for a variety of qualified education expenses, including tuition, books, supplies, and certain educational services. This flexibility allows you to address various educational needs.
3. Investment options: Coverdell ESAs offer a range of investment options, including stocks, bonds, mutual funds, and other securities. This allows you to potentially grow your savings over time by investing in different assets.

Cons:

1. Contribution limits: There is an annual contribution limit per beneficiary for Coverdell ESAs. As of 2021, the limit is $2,000 per year. If you exceed this limit, you may face penalties and taxes on the excess contributions.
2. Income restrictions: Coverdell ESAs have income eligibility requirements. The ability to contribute to a Coverdell ESA begins to phase out for single filers with modified adjusted gross income (MAGI) above $95,000 and joint filers with MAGI above $190,000 (2021 limits). This means high-income earners may not be able to take advantage of the account.
3. Age restrictions: The beneficiary of a Coverdell ESA must be under the age of 18 when the account is established unless they have special needs. This age restriction can limit the timeframe for saving and utilizing the funds for education expenses.
4. Limited contribution period: Contributions to a Coverdell ESA must cease when the beneficiary turns 18, and the funds must be used by the time they reach age 30. Any remaining funds after this period may be subject to taxes and penalties.

Coverdell ESA Summary:

Coverdell plans are decreasing in popularity, due in large part to the emergence of 529 plans. Depending on the student’s family income, a Coverdell ESA may not be an option at all.

UNIFORM GIFT TO MINORS ACT ACCOUNT

A UGMA (Uniform Gifts to Minors Act) account can be a viable option for education savings, but it has some important considerations to keep in mind. Here are the pros and cons of using a UGMA account as an education savings vehicle:

Pros:

1. Flexibility: UGMA accounts are not limited to educational expenses. The funds can be used for a wide range of purposes that benefit the minor, providing flexibility in case the child does not pursue higher education.
2. Simplicity: Setting up a UGMA account is straightforward and less complex than some other types of accounts.
3. No Contribution Limits: Unlike 529 plans, UGMA accounts do not have annual contribution limits, though large contributions may incur gift tax implications.

Cons:

1. Tax Implications: Earnings in a UGMA account are subject to the "kiddie tax" rules, meaning a portion of the income could be taxed at the parent's rate if it exceeds a certain threshold.
2. Financial Aid Impact: UGMA accounts are considered assets of the minor, which can significantly affect financial aid eligibility.
3. UGMA accounts are irrevocable and provide no tax benefits to the donor.
4. Control Transfer: Once the minor reaches the age of majority (typically 18 or 21, depending on the state), they gain full control over the account and can use the funds for any purpose, not just education.

UGMA Summary:

UGMA accounts are a form of a Trust set up on behalf of the beneficiary. They offer flexibility regarding investment types and how the accumulated assets are used, but their irrevocable structure and transfer of control features need to be clearly understood. For dedicated education savings with tax benefits, a 529 plan is often the better option.

ROTH IRA

A Roth IRA (Individual Retirement Account) can be a good option for education savings under certain circumstances. Here are the pros and cons to consider:

Pros:

1. Tax Benefits: Contributions to a Roth IRA are made with after-tax dollars, and the earnings grow tax-free. Qualified withdrawals in retirement are also tax-free.
2. Flexibility in Use: Roth IRAs offer significant flexibility. While they are intended for retirement savings, you can withdraw contributions (not earnings) at any time without penalties or taxes. This can be useful if you need to access funds for education expenses.
3. Penalty-Free Withdrawals for Education: Roth IRAs allow you to withdraw earnings penalty-free (but not tax-free) for qualified education expenses, such as tuition, fees, books, and supplies. This can be beneficial if you need additional funds beyond your contributions.
4. No Impact on Financial Aid: Roth IRAs are not counted as assets on the Free Application for Federal Student Aid (FAFSA), potentially preserving eligibility for financial aid.

Cons:

1. Contribution Limits: Roth IRAs have annual contribution limits ($6,000 for 2023, or $7,000 if you are 50 or older). This may limit the amount you can save compared to other dedicated education savings accounts.
2. Income Limits: There are income limits for contributing to a Roth IRA. For 2023, the ability to contribute begins to phase out at a modified adjusted gross income (MAGI) of $138,000 for single filers and $218,000 for married couples filing jointly.
3. Potential for Reduced Retirement Savings: Using a Roth IRA for education expenses can reduce the amount saved for retirement, which might impact your long-term financial security.

Roth IRA Summary:

A Roth IRA can be a good education savings option if you value flexibility and tax advantages, and you are confident in your ability to balance education and retirement savings goals. It is particularly useful if you anticipate that you might not use all the funds for education and prefer the option of using the savings for retirement if necessary.

TAXABLE SAVINGS AND INVESTMENTS

Using a taxable savings or investment account for education funding has its pros and cons, and its suitability depends on your financial goals, risk tolerance, and how accessible you want your savings to be for any purpose your require. A key advantage of this option is that nearly every family already has such accounts in place, so this option can be used to complement any of the previous education savings options discussed.

Here is a breakdown to help you decide if this is the right choice for you:

Pros:

1. Flexibility: Funds in a taxable savings or investment account can be used for any purpose, not just education. This makes it a flexible option if your child's educational path is uncertain or if you anticipate needing the funds for other purposes.
2. No Contribution Limits: Unlike specific education savings accounts like 529 plans or Coverdell ESAs, there are no limits on how much you can contribute to a taxable savings or investment account.
3. Easy Access: You can access the money in a taxable savings or investment account at any time without penalties, making it a convenient option for immediate or short-term needs.
4. No Income Restrictions: Unlike some education savings accounts, there are no income restrictions for contributing to or maintaining a taxable savings or investment account.

Cons:

1. Earnings are taxed: Interest, dividends, and realized capital gains earned in a taxable savings or investment account are subject to federal and state income taxes. This can reduce the overall return on your investment compared to tax-advantaged accounts like 529 plans.
2. Low Returns on Savings Accounts, CDs and Savings Bonds: these options typically offer lower yields via their interest rates compared to other investment options, such as stocks, mutual funds or ETFs. These returns will not keep up with the rising cost of education over time.
3. Impact on Financial Aid: Money in a taxable savings or investment account is considered a parent’s or student's asset when applying for financial aid, which can potentially reduce the amount of aid received.

Conclusion:

A taxable savings or investment account can be a good supplementary option for education funding, particularly if you value flexibility and immediate access to funds. However, it may not be the most efficient vehicle for maximizing your savings due to the tax implications and potentially lower long-term returns compared to dedicated education savings accounts like 529 plans or Coverdell ESAs.

COMPARING THE OPTIONS

We rank each of the referenced options against each other below.

CONTRIBUTION LIMITS

Best Option: Taxable Savings and Investment Accounts, which have no contribution limits.

Runner Up: Tie between 529 plans and UGMA, which have a very high contribution limits in most states. However, contributions to these accounts are limited by Gift Tax limits ($18,000 per person in 2024).

Others: Roth IRA contributions are capped (2024 is $7,000)

Coverdell is the worst in this category at a limit of $2,000 per year, per beneficiary.

INCOME LIMITS ON CONTRIBUTORS

Best Option: Tie between 529 Plans, UGMA Accounts, and Taxable Savings and Investment Accounts, which have no income limits on those who make contributions.

Others: Both Roth IRAs and Coverdell ESAs have income limits on contributors.

USE OF ACCUMULATED FUNDS

Best Option: Taxable Savings and Investment Accounts, which have no limits on how the accumulated funds are used. If you are only using the contributions made to a Roth IRA, there is no limit on how these funds are used, either.

Runner Up: I include both UGMA and 529 Plans in this tier, for different reasons:

Contributions to a UGMA are irrevocable, and withdrawals from a UGMA must benefit the beneficiary. Also, the ownership of the UGMA account transfers to the minor once they reach the age of majority (typically 18 years old), giving them the ability to use the UGMA assets for any purpose they desire, even if that purpose is not what was intended by the parent/contributor.

Due to recent changes in regulations, 529 funds can be used for the original beneficiaries qualified education expenses, alternate qualified beneficiaries' education expenses, or a portion can be rolled into a Roth IRA for the 529 beneficiary. This allows an improvement in options for using 529 funds that are in excess of the beneficiary's educational needs.

Others: If you use accumulated earnings in the Roth IRA account, taxes and potential penalties will apply.
A Coverdell ESA must be used for qualified education expenses and must be depleted by the time the beneficiary turns 30 years of age.

IMPACT ON FINANCIAL AID

How Financial Aid is calculated is complex, and beyond the scope of this paper. In general terms, various types of assets are assessed for availability to be used to fund the child's education. For our ratings below, the key factor we consider is that the child's assets are viewed by FAFSA as more available for use toward their education than the parent's assets.

Best Option: Roth IRA, which has no impact on FAFSA calculations.

Runner Up: 529 Plans, Coverdell ESAs and Taxable Accounts held by the parents. FAFSA expects up to 20% of the student's assets to be available for education cost use, but only about 6% of the parents' assets to be available for education use.

Others: UGMA has the most significant impact on financial aid, as the assets are considered owned by the child (student). If a taxable savings or investment account is in the child's name, this will also have a significant impact on financial aid eligibility.

INVESTMENT FLEXIBILITY AND FEES

This is another complex category, and the rankings can vary based on the institution that is used to manage the accounts and investments. For example, many banks offer IRAs, 529 plan access and investment options, but they are often very limited re: options compared to institutions such as Fidelity, BlackRock, Vanguard and other large investment brokerage institutions.

Best Option: Taxable Savings and Investment Accounts, which offer the widest range of investment types and typically allow the account owner to pursue options with minimal fees and commissions. UGMA accounts are also very flexible regarding investment types, but are limited to financial assets, such as cash, stocks, bonds, mutual funds / ETFs and insurance products.

Runner Up: Tie between Coverdell ESAs and Roth IRAs, if established at a brokerage with a wide variety of investment options, such as Fidelity, Vanguard, BlackRock, etc.. If the ESA or Roth IRA was established at a bank, it likely has minimal investment options.

2nd Runner Up: 529 Plan investment options vary significantly by 529 Plan Administrator, but many offer a broad range of equity and fixed income investment options. 529 Plans have higher fees, in general, than the higher-rated options in this category, yet many 529 plans offer reasonable fees.

TAX IMPLICATIONS

Best Option: 529 Plans offer tax-free earnings accumulation and distributions for qualified education expenses are also tax-free. In addition, some states offer income deductions or tax credits for 529 Plan contributions.

Runner Up: Coverdell ESAs offer tax-free earnings accumulation and distributions for qualified education expenses are also tax-free. However, their contribution and income limits limit the tax advantages vs. a 529 Plan.

Others: UGMA accounts may offer a tax advantage, as certain account income will be taxed at the child's rate, which will be lower than the parent's income tax rate.

If a parent depletes their Roth IRA to use contributions to pay for educational expenses, they eliminate the tax-free earnings growth on those funds. If possible, we encourage clients to avoid using retirement account funds for education costs due to the opportunity cost of removing assets that are eligible to grow in a tax-free or tax-deferred manner.

Taxable savings and investment accounts offer no tax savings advantages.

BOTTOM LINE

As with other kinds of investing, the earlier you get started with an Education Savings plan, the better. For any of the options listed above, starting contributions as early as possible will allow your investments to have more time to leverage the advantage of compounding. For a well-rounded education savings strategy, consider using a combination of the options presented. For example, you might use a 529 plan for long-term growth and tax advantages while maintaining a taxable savings account for flexibility and short-term needs.

Since the range of options is broad, and education savings plan decisions need to take into account many factors including those presented earlier in this paper, consulting with a Financial Advisor with Education Saving expertise will likely help you fully assess your options and build a plan that best meets your objectives.

RESOURCES

The articles below were referenced in preparing this information and are excellent resources to better understand this topic.

1. https://www.eustaceadvisors.com/blog/advantage-time-investor.
2. https://www.usa.gov/estimate-college-cost
3. https://educationdata.org/average-cost-of-college
4. https://www.bankrate.com/investing/529-plan-disadvantages/.
5. https://www.morningstar.com/personal-finance/morningstar-529-ratings-best-plans-2023
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