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The Adviser's Guide to Education Planning

Ross A. Riskin, CPA/PFS

1st edition

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The PFP Section is the premier provider of information, tools, advocacy, and guidance for CPAs who specialize in providing estate, tax, retirement, risk management, and/or investment planning advice to individuals, families, and business owners. Learn more at aicpa.org/PFP. All AICPA members are eligible to join the PFP Section.

Note: The additional resources that this guide references on the PFP Section website are included with membership in the PFP Section (this includes all CPA/PFS credential holders). Non-members can purchase some of these resources on the AICPA Store at www.aicpastore.com.

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Preface

This guide covers education planning A-Z and can be your go-to source for helping clients with all things education-related. Check out planning tips, real-life examples, comparison tables and more in the full guide, available to PFP Section members, inclusive of CPA/PFS credential holders!

Why should you care about education planning?

The CPA trusted adviser is in a unique position to assist clients with education planning based on his or her understanding of a range of personal financial planning concerns, especially tax planning. Effective education planning can occur when families work with a trusted adviser who can accurately assess what they wish to achieve in order to provide guidance and practical objectives to help them and their children reach their personal, professional, financial, and academic goals. Education planning requires CPAs to be knowledgeable about tax planning, financial aid planning, and cash flow planning, and more importantly, to be aware of how each of these planning areas interact with one another so families can receive holistic guidance.

Becoming a primary point of contact or a specialist in this area

CPAs and CPA financial planners are strategically positioned to help fill the gap in services that exist for millions of students and families throughout the country. This gap has been created partly by guidance counselors throughout the country who have been diligently focused on helping students find the “best fit school” without properly being able to advise families on the financial ramifications and partly by financial advisers who have focused primarily on recommending families to save for college using a 529 College Savings Plan yet fail to offer any further guidance when it comes to filling out financial aid forms, discussing customized tax planning strategies, or evaluating student loan options and repayment plan strategies.

Whether CPAs and advisers are looking to create additional revenue streams by offering this niche service to existing/prospective clients, or are simply looking to add value to maintain their existing relationships, becoming the primary point of contact amongst other advisers or a specialist in education planning will help the CPA leverage his or her position as an innovative forward-thinking adviser and partner for their clients on their path to financial success.

How to use this guide

This is meant to be a practical guide that blends information and planning guidance in a way that will help you serve your clients’ best interests.

Look at this icon for important planning tips based on the information.

Chapter 1: Getting started

Education planning process

- Gather objectives, needs, and costs
- Assess potential for financial aid
- Assess funding methods available
- Assess funding strategies
- Develop and present recommendations
- Implement, monitor, and update the plan

The items listed above highlight the education planning process as per the AICPA's [personal financial planning body of knowledge](). One of the first things we need to do with clients when starting an education planning engagement is to know what the age of the child is as this will likely drive the focus of our discussions and planning.

Age of Child	0-14	15-22
Primary Focus	Saving for college	Paying for college
Planning Strategies	Tax planning Cash flow planning	Financial aid planning Tax planning Cash flow planning Debt management planning

Education funding

We know that while saving for college and higher education expenses is a concern for most families, the focus on developing a funding strategy that comes primarily from savings should be for clients/families with young children between the ages of 0 (newborn) and 14. Developing an appropriate education funding strategy early on is critically important as our clients will have time on their side and therefore, the ability to maximize the future value of their savings through reinvestment and compound growth. It is important to run various calculations to see just how much the family needs to save over their respective time frame and what their tolerance for risk is. Below is a breakdown of the variables needed/involved in performing appropriate time value of money calculations along with some planning thoughts or conversations to have with your clients.

N or Number of Periods: This variable represents time, which we not only know is the most valuable resource for all of our clients, but it is also one variable that is used in a plethora of ways when determining what the target education savings goal is for your clients. Here are some examples of where we will need to have conversations about or make reasonable assumptions when it comes to incorporating the element of time into our computations and analysis.

- How long will it be until the child first enrolls in college?
- How many years do we expect the child to be enrolled in college?
- How often will we be able to set aside money to save for college?
- How long do we wish to save for college? (stop when the child becomes a freshman or continue to save throughout their college career)

I or Rate: This variable will represent either the assumed rate of inflation you are using to project what the cost of attendance will be in the future or it will be used when making rate of return assumptions for your clients' investments. Historically, college costs have grown annually between 5 and 6% while general inflation has increased at around 2-3%. Two important things to keep in mind are that while college costs are rising across the board, certain types of schools may be affected differently; for the 2007-2008 and 2008-2009 academic years, The California State University system implemented 10% tuition increases[1], and the second thing is that it is not only important to look at the rate of inflation but the base cost that is being inflated; an 8% increase on $10,000 of tuition is $800 while a 3% increase on $55,000 of tuition is $1,650.

PLANNING TIP: When running calculations, it is better to overestimate the rate of inflation of college costs and understate the rate of return anticipated on savings/investments. In doing so, we acknowledge that projecting accurate inflation rates and investment returns is impossible, but by erring on the side of conservativeness for both estimations, we attempt to ensure that the client saves enough or perhaps "oversaves" for college. This is a better problem to have than under saving, since, if the client does end up saving more than was needed, they may be able to use these proceeds for graduate school or other expenses depending on which savings vehicle(s) they have utilized.

PV or Present Value: This variable represents the funds that have already been accumulated and set aside to pay for college costs in the future. When determining what has already been saved, you have to go beyond simply asking the client if they have a 529 College Savings Plan or Coverdell Education Savings Account (CESA) set up, as your clients may be using other vehicles to save either in addition to these or in isolation perhaps because they were unaware of the benefits of these aforementioned vehicles. You also need to talk with your clients about who else may be saving for the child such as aunts, uncles, and grandparents, as you want to make sure you are considering all sources of savings and that lines of communication are open and clear between all parties who have a vested interest in helping pay the future costs of college for the child/children.

[1] https://www2.calstate.edu/csu-system/about-the-csu/budget/2017-18-support-budget/supplemental-documentation/Pages/historical-tuition-rates.aspx

FV or Future Value: This variable will be used when you are projecting what the first year of college will be assuming an agreed upon rate of inflation for a certain number of periods. It will also be used when figuring what the total amount the client will be saving towards, taking into consideration how long he or she will be saving, inflation, rate of return, and what funds have already been set aside.

PMT or Payment: This variable often becomes the focus of your calculations because at the end of the day, your clients need to know just how much they should be saving each week, month, year, etc. As CPA financial planners, you should be familiar with the underlying concepts of time value of money and should know that as other variables (N, I, PV, and FV) change, so will the client's required savings amount.

A good way to further illustrate how much a client needs to save to accomplish their goals is to show them what it would look like if their son or daughter were to attend a private college versus public college in the future since this choice will have a major impact on the savings needed. If the client has a younger child(ren), it is highly probable that they will have no idea where their son or daughter will attend (actual decision), will want to attend (desire or preference), or will be able to attend (grades, standardized testing, etc.).

Private college example

Age of Child	Funding %	Beginning Savings Balance	Annual Cost of Attendance	Inflation Rate	Future Cost of Attendance (Freshman Year)	Projected Total Cost of Attendance (Four Years)	Rate of Return	Target Monthly Savings Goal
10	100%	$0	$61,275	5%	$90,531	$390,200	5%	**$3,300**
	50%					$195,100		**$1,650**
	25%					$97,550		**$825**

Monthly Cash Inflows	Monthly Cash Outflows	Monthly Net Cash Flow
$8,300	$6,800	**$1,500**

Public college example

Age of Child	Funding %	Beginning Savings Balance	Annual Cost of Attendance	Inflation Rate	Future Cost of Attendance (Freshman Year)	Projected Total Cost of Attendance (Four Years)	Rate of Return	Target Monthly Savings Goal
10	100%	$0	$29,038	5%	$42,902	$184,914	5%	**$1,564**
	50%					$92,457		**$782**
	25%					$46,229		**$391**

Monthly Cash Inflows	Monthly Cash Outflows	Monthly Net Cash Flow
$8,300	$6,800	**$1,500**

Another helpful planning strategy is to incorporate at least two scenarios for each type of school. The examples above show what the client would need to save on a monthly basis in order to pay for 25%, 50%, or 100% of the projected college costs, respectively and also assumes the client saves at the beginning of each month and stops saving when the child starts college. As you can see, the client is currently in a position to save for almost 50% of the college costs at a private college and almost 100% at a public college. Presenting a variety of options may help the client feel motivated and hopeful rather than pressured to save for all four years of college, and it may encourage them to discuss their own college funding philosophies more openly with you.

PLANNING TIP: *"I want to pay for all four years of my child's college."*
"I want to pay for their first two years of school only."
"I will only help pay if they keep their grades up and after they have some skin in the game as well."
"I paid my way through college and so should my kids."

It is extremely likely that your clients have shared at least one of these funding philosophies with you. Your job as an adviser is not to judge the client or push your own philosophy or agenda on them. Instead, your role is to listen and then make recommendations that not only help them achieve their goals but also expand their understanding so they can learn and grow themselves, and for couples, seek to develop consensus concerning their child or children's education.

Talking about how college will be paid for and who is responsible for footing the bill can become emotional, and you have to do your best to help identify biases the client may be exhibiting and should understand if they are emotional or cognitive in nature. Emotional biases are often rooted deep and difficult to change so we must manage both our expectations of the client around these while also advising them with objectivity. Cognitive biases often arise from some information processing error and can either be corrected or you can use your ability to empathize and understand how your clients learn in order to help them think and act more logically in the future.

Regardless of which funding philosophy is chosen, it is extremely important for parents, children, grandparents, guidance counselors, and CPA financial planners to all be on the same page. Too often parents make decisions without consulting available experts, or at least consulting their children, when it comes to paying for college whether it be from savings or borrowed funds, and the damage that can be done from this lack of communication will surely last longer than four years.

After comparing how much the client would need to save each month in order to fund multiple years of college, it is important to run a comprehensive cash flow analysis if this hasn't been done already to see what the family can ACTUALLY afford to save. After the cash flow analysis has been reviewed, projected expenses have been cut, and a revised target savings amount has been determined, you now need to figure out where the client should be saving; which vehicles are most appropriate to use to help the client accomplish their goals.

PLANNING TIP: Take a holistic approach that considers qualitative and quantitative factors when attempting to increase cash flow/reduce expenses. Some expenses may look easy to cut or tell the client to cut, but the psychological impact of removing them may have detrimental long-term effects that should at least be considered. For example, when evaluating a client's list of monthly expenses, you may determine that they should cut back on dining out. What you may not realize is that both parents work stressful jobs while the kids are in school all day and are pre-occupied with camps and sports activities after class and eating out once or twice a week is one of the few things the family is able to enjoy doing after a stressful week. Therefore, while it is very likely that you have a great quantitative system in place for helping clients improve cash flow, remember that there are critical qualitative factors at play behind the numbers as well.

When evaluating where clients should be saving for college or which vehicles they should be using, it is best to consider the following four factors in your criteria:

	Operational Flexibility	Investment Flexibility	Tax Efficiency	Financial Aid Efficiency
529 College Savings Plan	Good	Average	Good	Good
Coverdell Education Savings Account	Below Average	Good	Good	Good
Roth IRA/Traditional IRA	Average	Good	Good	Good
UGMA/UTMA Custodial Account	Good	Good	Below Average	Below Average
Taxable Investment Account	Good	Good	Below Average	Average

Qualified tuition programs (529 College Savings Plans)

Qualified tuition programs are made up of both savings plans and prepaid plans under IRC Section 529. This guide will only be focusing on savings plans since they are more widely used by investors and there are more options available in the current marketplace; there are nineteen prepaid plans in existence, only eleven of them are accepting new applicants, and nine of the eleven have residency requirements.

A 529 College Savings Plan is a tax-advantaged savings vehicle that allows families to save for qualified higher education expenses. Additionally, under the Tax Cuts and Jobs Act of 2017 (TCJA) up to $10,000 of K-12 tuition expenses, in the aggregate per year per beneficiary, may be treated as a qualified distribution if these funds are used to pay for public, private, or religious elementary or secondary school tuition expenses.

Example

	Conor	Sarah	Michael
Grade	5th	7th	HS Freshman
Type of School	Private	Private	Private
Tuition Expenses	$6,500	$9,000	$18,000
529 College Savings Plan Distribution	$7,500	$9,000	$18,000
Qualified Distribution	$6,500	$9,000	$10,000
Non-Qualified Distribution	$1,000	N/A	$8,000

Operational flexibility: From an operational flexibility standpoint, setting up an account is fairly straight forward. Individuals must often choose between investing in a direct-sold plan or an advisor-sold plan (see below), and they can also choose between investing in a plan offered by their own state or by another state that accepts outside contributions. When setting up each plan, the contributions must come in as “cash,” and a sole account owner and sole beneficiary must be designated. Let’s expand on each of these items below before we move on to discussing the investment flexibility of this type of savings vehicle.

Direct-sold vs. advisor-sold: Most states offer the choice of investing in either a direct-sold plan, in which the individual invests directly with the state; or an advisor-sold plan, in which they invest with a broker who then manages the investments within the 529 College Savings Plan. Some states may offer only one option and some do not offer any 529 College Savings Plan options. In general, it is best for clients to consider investing in direct-sold plans as they are usually more cost effective and will typically offer very similar investments as compared to their advisor-sold plan counterparts. It is also important to note that historically, a greater number of direct-sold plans have received higher ratings under the Morningstar 529 College Savings Plan rating system, which rates plans at the overall level based on five factors; process, people, parent, price, and performance, since 2012.

In-state plan vs. out-of-state plan: Many 529 College Savings Plan participants choose to invest in their own state's plan; however, as mentioned above some states do not offer a plan. In these cases, and even in instances where a client's state of residence does offer a 529 savings plan it may be wiser or more prudent to invest in the savings plan offered by another state if it is a superior offering. The majority of 529 plans accept contributions from non-residents. You may want to consider using the Savingforcollege.com tool to verify what the contribution rules and restrictions are for each plan while also gathering prospectus information from each respective plan's website at a minimum.

Changing things around: *"What if my child doesn't end up using the funds I have saved for him or her in the 529 college savings account?"*

"What if my child qualifies for a full-ride scholarship?"

You have probably received these questions from clients in the past and the good news is the flexibility of 529 plans answers these questions. If for some reason, the funds your client has accumulated for the child will not be needed to cover the costs of undergraduate or graduate studies, another member of the "family" can be designated as the beneficiary without deeming this "transaction" a distribution. The beneficiaries can be changed once per 12-month period per each plan. The term "family" carries a pretty broad definition as can be seen in the chart below[2].

Qualifying Family Members
The designated beneficiary's spouse
The designated beneficiary's son or daughter or descendant of the beneficiary's son or daughter
The designated beneficiary's stepson or stepdaughter
The designated beneficiary's brother, sister, stepbrother or stepsister
The designated beneficiary's father or mother, or ancestor of either parent
The designated beneficiary's stepfather or stepmother
The designated beneficiary's niece or nephew
The designated beneficiary's aunt or uncle
The spouse of any individual listed above, including the beneficiary's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law
The designated beneficiary's first cousin

[2] IRC Section 529(e)(2)(A)-(D)

PLANNING TIP: When a 529 College Savings Plan is setup and initially funded, a gift has been made if the beneficiary is set up as someone other than the account owner. If the beneficiary is then changed to another member of the "family" and that family member is within the same or a higher generation as the donor, no tax consequences will follow from either an income or transfer tax perspective.

Any excess funds in a 529 College Savings Plan can always be "transferred" to another member of the family or could potentially be used for graduate school without incurring any penalties or negative tax effects.

Distributing funds: Distributions from 529 College Savings Plans can be distributed to three parties:

- Beneficiary
- Account owner
- Qualified educational institution

Ideally, distributions should be made to either the beneficiary or the account owner, with a preference being for the beneficiary, because it is very common for families to overdraw from 529 College Savings Plans or use the funds for non-qualified expenses, for which the earnings on the distribution would likely be subject to taxes and possibly a 10% penalty. If this occurs, the distribution should be made to the child since they would likely be taxed at a lower rate; however, given the recent changes in the "Kiddie Tax" rules under the TCJA, you need to be cognizant of what other unearned income the child would be receiving since they would now be subject to the higher trust and estate tax rates at lower income thresholds.

What if I withdraw too much money?

Due to recent legislative changes, 529 College Savings Plan account owners are afforded two options should they mistakenly take out too much money from an account in any given year.

- Deposit the excess funds into another 529 College Savings Plan account for the same beneficiary within 60 days (only allowed one tax-free rollover per 12-month period)
- Deposit the excess funds into another 529 College Savings Plan account for a different beneficiary within 60 days

PLANNING TIP: Distribution concerns
Two important items to consider deal with distributions from this type of funding vehicle. The first deals with the proper timing of distributions. Although there is no definitive guidance from the IRS, the best rule of thumb to follow is that distributions from 529 College Savings Plans should occur in the same tax year the expenses are actually incurred. This shouldn't be too much of a challenge except in the first year

when the student will likely receive a tuition bill for Spring semester in December and need to decide whether to pay it in December or in January of the following year (depending on the due date of the bill).

Let's assume the following:

- Student takes a distribution of $25,000 from his 529 College Savings Plan in August 2018
- Student pays the fall tuition bill of $25,000 in September 2018
- Student receives the spring tuition bill in December 2018
- Student takes a distribution of $25,000 from his 529 College Savings Plan in December 2018
- Student pays the spring tuition bill of $25,000 in January 2019
- 2018 529 College Savings Plan distributions: $50,000
- 2018 qualified higher education expenses (QHEE): $25,000

In this scenario, half of the total distributions made in 2018 would be deemed non-qualified distributions with the earnings subject to taxation and possibly a 10% penalty. So, it is important for your clients to time their distributions carefully and make sure they are occurring in the same tax year the qualified expenses are incurred.

The second item to consider is how much of the distribution is classified as earnings and how much as principal. Unlike distributions from Roth IRAs, distributions from 529 College Savings Plans are allocated between principal and earnings on a pro-rata basis. However, this only becomes an issue if funds are distributed for non-qualified expenses.

Let's assume the following:

- Current value of 529 College Savings Plan: $100,000
- Earnings portion: $25,000
- Principal portion: $75,000
- Distribution of $25,000 from the account is made in 2018

(Earnings / Total Account Balance) x (Distribution) = Earnings Portion of Distribution

($25,000 / $100,000) x $25,000 = $6,250 earnings portion
The remaining $18,000 of the distribution is treated as principal

If you also assume $12,000 of the distribution is deemed to be non-qualified, the following calculation would be made:

$12,000 / $25,000 = 48% non-qualified portion

48% x $6,250 earnings portion or $3,000 would be subject to taxation and possibly a 10% penalty

Investment flexibility: From an investment flexibility standpoint, 529 College Savings Plans are above average but not great. One positive is that there are high funding limits in place that are determined by each plan, which typically reach as high as $300,000 per account. Investment options will vary within each plan, but they primarily consist of mutual funds and age-based mutual fund portfolios that gradually shift their fixed income asset allocation higher as the beneficiary becomes older and moves closer to reaching age 18 (college-aged). Be aware that some plans offer limited individual investment options, static portfolios, and managed age-based portfolios. However, clients can only invest in what the plan provides and cannot choose alternative or individual investments such as Apple Inc. stock or a Vanguard mutual fund if they are not already provided within the plan.

When making recommendations related to age-based portfolios keep in mind that:

1. Not all age-based portfolios are the same!

Asset allocations within age-based portfolios will vary, sometimes greatly, between different 529 College Savings Plans, so it is important that you review these allocations or at least make sure you are making an apples-to-apples comparison when evaluating 529 College Savings Plans for your clients to consider. The age bands may also differ as well. For example, consider the age bands for determining appropriate asset allocations for the following 529 College Savings Plans:

529 College Savings Plans: Age Bands

CHET 529 College Savings Plan (CT)	Ohio College Advantage 529 College Savings Plan (OH)
0-4	0-4
5-8	5-6
9-10	7-8
10-11	9-10
12-13	11-12
13-14	13-14
15	15-16
16	17-18
17	19+
18+	

2. There may be different levels of risk exposure within each age-based portfolio.

Many age-based portfolios use different asset allocations and levels of risk exposure and are often defined as conservative, moderate, or aggressive. So not only do we need to help our clients decide whether or not to use an age-based portfolio, we need to run a risk tolerance assessment as well to determine exactly which age-based portfolio is appropriate given both the client's ability and willingness to take on risk. It is also important to remember that the equity exposure within similarly labeled age-based portfolios may vary greatly between plans.

529 College Savings Plans: Equity Allocations	
Pennsylvania 529 Investment Plan (PA)	LearningQuest 529 Program Direct (KS)
Moderate: Age 11-15 Medium Equity Band	Moderate: Age 12-14 Medium Equity Band
31.43%	55.17%

3. Now that the funds can be used for K-12 tuition expenses under the TCJA, solely using age-based portfolios may not be appropriate/optimal for your clients if they have multiple education funding goals for the same child.

With the expansion of the tax-advantaged uses of 529 College Savings Plan funds to now include qualified K-12 tuition expenses, the definition or underlying assumptions of these age-based portfolios may be thrown into question for many plans throughout the country. For instance, what if a family decides they are using the 529 College Savings Plan to save for high school instead of college? Most age-based portfolios would not be conservative enough (too much of the portfolio would be invested in equities) for most clients since the family would likely be looking to take distributions from the funds when the child reaches age 14 or 15 rather than 18 or 19. Three years may not seem like a big deal, but it is a long period of time relative to the time horizon for the funding event versus recommending the use of a target-date fund for retirement planning purposes for someone who decides they may retire in 37 years instead of the originally planned 40.

Another limitation to point out is that account owners may only make two investment changes within a beneficiary's account in any calendar year (was limited to one change prior to 2014). However, it is not often clear what constitutes an investment change so please see the chart below for further guidance.

Action	Investment Change
Moving funds from same state direct-sold plan to same state advisor-sold plan	Yes
Underlying investments change within selected plan/investment	No
New investment option selected for new contributions only	No
Reallocating multiple investment options within plan to new investment options	Yes, but counted as only one investment change if the reallocations occur at the same time

Tax efficiency: Perhaps the biggest advantage of using a 529 College Savings Plan is that investments made within the plan grow tax-deferred and can eventually be withdrawn tax-free if the distributed funds are used to pay for qualified education expenses. Some examples of qualified education expenses would be the following:

- Tuition
- Room and board
- Fees
- Books and supplies
- Technology and equipment

"Can 529 College Savings Plan funds be used if my child lives off-campus?"

Room and board expenses are considered qualified higher education expenses if the student is enrolled at least half-time and the expenses are paid directly to the college with an exception for students living off-campus. Students who choose to live off-campus can still use these funds, but any amounts paid that exceed the college's room and board estimate would not be considered a qualified higher education expense. For example, if the student takes a distribution of $15,000 to pay housing expenses to live on the beach with classmates while his or her college's room and board estimate is $13,000, $2,000 would not be considered a qualified higher education expense and the earnings portion associated with $2,000 of the distribution would be subject to taxes and possibly a 10% penalty.

For more detailed information on these qualified expenses, please see the chart within the Education tax deductions and credits planning section (chapter 3).

Another added benefit is that 33 states and the District of Columbia currently allow for income tax deductions for qualified contributions that are made to state 529 College Savings Plans for residents up to a certain limit. For example, the CHET 529 College Savings Plan (Connecticut) allows for a maximum annual state income tax deduction up to $10,000 for married filing joint taxpayers and $5,000 for individuals (with any additional or unused contribution amounts being carried forward for five years). However, it is important to review the policies of each state plan since it is possible that additional requirements will need to meet in order to receive the state income tax deduction or that only certain individuals can receive the deduction.

Colorado Example: Currently, contributors to the three Colorado direct-sold 529 College Savings Plans may take a state income tax deduction up to the extent of their taxable income. So, if a Colorado resident wants to contribute $50,000 into the Smart Choice College Savings Plan, he/she can receive a $50,000 state income tax deduction provided he/she has at least this amount in state taxable income prior to applying the deduction.

Kansas Example: Contributions of up to $3,000 made by an individual or $6,000 by a married filing jointly couple per beneficiary per year may be claimed as a state income tax deduction whether the contributions are made to a Kansas or non-Kansas state-sponsored 529 College Savings Plan.

Virginia Example: Contributions from a non-owner are deductible by the account owner only and not by the non-owner/contributor. So, if grandma decides to make a $4,000 contribution to the Invest529 Plan owned by dad, dad is entitled to a $4,000 state income tax deduction rather than grandma.

In a sense, 529 College Savings Plans receive a triple tax benefit if the contributions can be at least partially deductible at the state level, the contributions can grow tax-deferred, and the distributions can be taken tax-free, similar in a way, theoretically, to how a Health Savings Account (HSA) works.

Financial aid efficiency: From a financial aid efficiency standpoint, 529 College Savings Plans are excellent. In the section covering financial aid planning (chapter 2) will be a discussion about what assets are assessed and how they are assessed under the various financial aid formulas; but in general, 529 College Savings Plans are considered parent assets and are therefore, assessed more favorably (lower rate and with certain allowances provided) than student assets (higher rate and no allowance protections). Section 529 College Savings Plans, whether the account owner is the parent or student, are assessed as parent assets for financial aid purposes. Distributions from accounts owned by parents or students are not taken into consideration (not treated as untaxed income) for financial aid purposes and will therefore, not negatively impact the student's aid eligibility.

529 College Savings Plans end up being one of the best education funding vehicles, as you may have already known or suspected; however, some issues still arise that we need to be aware of for planning purposes.

PLANNING TIP: State income tax deduction vs. plan fees
Not only are the underlying fees of the chosen 529 College Savings Plan important to understand, it is also important to weigh those costs over time against the

immediate and "flashy" state income tax deduction benefits that are often pitched to clients.

Here is an example that analyzes the effectiveness of state income tax deductions while taking underlying plan fees into consideration.

Scenario 1: 529 College Savings Plan A

- Our client contributes $12,000 into their state's 529 College Savings Plan
- Our client is able to deduct the full contribution for state income tax purposes and is in a 7% state income tax bracket
- 529 College Savings Plan underlying fees (mutual fund expenses, administration expenses, etc.) are 1.5% per year
- 529 College Savings Plan will earn a 6% annual rate of return
- Value of state income tax deduction: $840
- Value of state income tax deduction invested at 6% per year after 10 years: $1,504
- Value of 529 College Savings Plan after 10 years: $18,518
- Total value after 10 Years: $20,021

Scenario 2: 529 College Savings Plan B

- Our client contributes $12,000 into an out-of-state 529 College Savings Plan
- 529 College Savings Plan underlying fees are .30% per year
- 529 College Savings Plan has a 6% annual rate of return
- Value of 529 College Savings Plan after 10 Years: $20,856

	529 College Savings Plan A	**529 College Savings Plan B**
Initial Contribution	$12,000	$12,000
State Income Tax Deduction	Yes	No
State Income Tax Rate	7%	N/A
Plan Underlying Fees (mutual fund expenses, administration expenses, etc.)	1.50%	0.30%
Rate of Return	6%	6%
Current value of State Income Tax Deduction	$840	N/A
Value of State Income Tax Deduction Invested (10 Years Later)	$1,504	N/A
Value of 529 College Savings plan (10 Years Later)	$18,518	$20,856
Total Net Value (10 Years Later)	**$20,021**	**$20,856**

As you can see, the value of receiving a state income tax benefit up-front from your client's home state plan may not outweigh the costs of high underlying investment fees over a given period of time (assuming a one-time contribution and equivalent rates of returns between plans). Therefore, it is important to analyze the underlying fees and the value of the state income tax deduction in unison.

PLANNING TIP: State income tax recapture
State income tax recapture is an issue that comes into play when a non-qualified distribution is made from a 529 College Savings Plan and the account owner/contributor previously benefited from receiving a state income tax deduction. Most states have recapture provisions, but they each calculate it a bit differently, so it is best to carefully research each plan's recapture provisions.

For example, Mississippi's Affordable College Savings Program[3] treats the principal portion of nonqualified distributions as includable in Mississippi taxable income to the extent prior state income tax deductions were taken for contributions made to the respective plan. For nonqualified distributions made from California's ScholarShare 529 Program[4], an additional 2.5% penalty tax is assessed on the earnings portion if the distribution is also subject to the 10% federal penalty.

"What if my client lives in a state that doesn't offer an income tax deduction for contributions made to the state's 529 College Savings Plan?"

If this is the case, then you don't need to worry about state tax recapture and should instead focus on the investment options and fees associated with the in-state and out-of-state offered plans when running your comparison analysis.

Coverdell Education Savings Accounts (CESA)

Coverdell Education Savings Accounts (CESA), formerly referred to as Education IRAs, are a tax-advantaged savings vehicle that allows families to save for higher education expenses and qualified K-12 expenses.

Operational flexibility: From an operational flexibility standpoint, CESAs can be set up at a bank or brokerage account with a sole account owner and a sole beneficiary being designated. In a similar fashion to how 529 College Savings Plans work, the beneficiaries of these accounts can be changed to another member of the "family" without being deemed a distribution.

Distributions can be made to the following parties:

[3] http://macsprogram.wpengine.com/wp-content/uploads/2017/06/MACS_Disclosure_Booklet.pdf
[4] https://www.scholarshare529.com/documents/ca_disclosure.pdf

- Beneficiary
- Account owner
- Qualified educational institution

However, one way in which these accounts differ from 529 College Savings Plans is that there are adjusted gross income (AGI) limitations in place which preclude higher income clients from easily utilizing CESAs.

2018 AGI limitations:

$190,000 - $220,000 (married filing jointly taxpayers)
$95,000 - $110,000 (single taxpayers)

Investment flexibility: From an investment flexibility perspective, CESAs have one major advantage and disadvantage when compared to 529 College Savings Plans. The advantage is that since these accounts are set up either at a bank or brokerage account, clients can invest in a much wider range of securities, as they are not restricted to investing in a given state plan's few mutual funds or age-based portfolios. The disadvantage is that CESAs have an annual funding/contribution limit of $2,000 per beneficiary from all sources. This means that if two parents and two grandparents wanted to equally contribute to an account for their 10-year-old daughter/granddaughter, they could each only put in $500 annually (assuming their respective incomes remain below the AGI phase-out).

Tax efficiency: These accounts receive the same tax-deferred and eventual tax-free growth benefits that 529 College Savings Plans do, assuming the distributed funds are used to pay for qualified education expenses (K-12 and beyond). However, state income tax deductions are not available for contributions made to these plans, so they are not as tax-efficient as 529 College Savings Plans for those living in states which offer income tax deductions for eligible contributions.

Financial aid efficiency: These accounts receive the same financial aid treatment as 529 College Savings Plans. CESAs owned by either the parent or the student are considered parent assets and are assessed at a more favorable rate in the financial aid formula calculations.

PLANNING TIP: Should your client transfer CESA funds to a 529 College Savings Plan?
This really depends on each family's situation. Here are some important things to keep in mind when considering a transfer:

- Transfers to 529 College Savings Plans must come in as cash, which means all the investment holdings in the CESAs will need to be liquidated prior to the transfer.

- Transfers to 529 College Savings Plans are also considered qualified expenses, so your client will not need to worry about incurring any penalties or income tax liability as a result of the "distribution."
- Financial aid treatment of both of these accounts is the same so that should not be a reason for transferring.
- Check with the individual state's 529 College Savings Plan provisions related to receiving a state income tax deduction for the transfer. For example, the CHET 529 College Savings Plan (Connecticut) specifically states that no state income tax deduction is allowed for transfers from CESAs.

The income limitations on this type of account may not eliminate it as a savings option for your higher income clients. However, funding this type of account to help pay for qualified K-12 and higher education expenses can be achieved if contributions are made by grandparents or other relatives who fall below the AGI phase-out range. One strategy that can be used to navigate around this limitation is to have your client gift $2,000 to a relative and then have them fund the CESA on behalf of the child.

Traditional and Roth IRAs

Traditional IRAs and Roth IRAs are savings vehicles that allow taxpayers to save for retirement on a tax-deferred and tax-free basis, respectively. When we think of Traditional or Roth IRAs, we usually associate these as being used exclusively for retirement planning purposes. While that is an accurate and preferred way to think of them, there are also a few ways in which they can be used effectively for college planning purposes.

Operational flexibility: From an operational flexibility standpoint, Traditional and Roth IRAs can be set up at a bank or brokerage account. Generally speaking, contributions and distributions can be made from and to the account owner only.

Investment flexibility: From an investment flexibility standpoint, Traditional and Roth IRAs operate in a similar way to Coverdell Education Savings Accounts (CESAs). Let's take a look at these accounts separately.

Traditional IRAs:

Annual contribution limit:

- $5,500 ($6,500 if over the age of 50) contingent upon earned income

2018 income limitations for deductible contributions (assuming both spouses are plan participants):

- $99,000 - $119,000 (married filing joint taxpayers)
- $62,000 - $72,000 (single taxpayers)

Keep in mind that there are no income limitations that restrict taxpayers from making a non-deductible IRA contribution, or a deductible contribution in cases where neither the client nor their spouse participates in an employer-sponsored retirement plan.

Roth IRAs:

Annual Contribution Limit:

- $5,500 ($6,500 if over the age of 50) contingent upon earned income

2018 Income Limitations for Contributions:

- $186,000 - $196,000 (Married Filing Joint taxpayers)
- $118,000 - $133,000 (Single taxpayers)

Tax efficiency: From a tax efficiency standpoint, both of these savings vehicles provide tax advantages, but in opposite ways. The best thing about these accounts is that distributions taken from either a Traditional IRA or Roth IRA that are used to pay for qualified higher education expenses avoid the 10% early withdrawal penalty. This penalty exclusion is not found in similar employer-sponsored retirement accounts such as Traditional and Roth 401(k)s. Another important thing to remember is that with Roth IRAs, distributions are counted as coming from principal first then earnings, so clients can always withdraw their original contributions tax and penalty free (assuming the account is 100% contributory).

Financial aid efficiency: When evaluating these accounts and other retirement savings vehicles for financial aid efficiency, things get interesting. These savings vehicles are not counted as assessable assets for financial aid purposes, but withdrawals of principal and/or earnings will count as income (either taxable or untaxed) for financial aid purposes. This means that you need to be strategic in the timing of distributions if your clients are going to be using these funds to make sure the distributions don't materially impact the student's financial aid eligibility.

Given that the financial aid income assessment years occur two years prior to the respective years in which payments are made, distributions from Roth IRAs should be taken **after the final income assessment year** for the student. Here is an example of how one could properly time these distributions for optimal financial aid planning efficiency.

	Income Assessment Year	Tax Years	Distributions Should be Taken
Freshman Year			
Fall 2019	2017	2019	No
Spring 2020		2020	No
Sophomore Year			
Fall 2020	2018	2020	No
Spring 2021		2021	Yes
Junior Year			
Fall 2021	2019	2021	Yes
Spring 2022		2022	Yes
Senior Year			
Fall 2022	2020	2022	Yes
Spring 2023		2023	Yes

PLANNING TIP: Multi-purpose vehicle (plan for retirement as well!)

Roth IRAs are great funding vehicles for students as well if they work summer jobs or have earned income from some other sources during the year. Students are able to contribute to these accounts if they have earned income and their income falls below the AGI phase-out limitations, which should be the case for most. Retirement assets are also not assessed for financial aid purposes, but distributions from these accounts are assessed as income so the timing of said distributions is critical.

If the student does not need to use funds from these accounts to pay for qualified higher education expenses, they will have at least gotten a head start on saving for retirement. $11,000 compounded tax-free at 6% over the next 45 years will equate to over $150,000 in future dollars or just over $61,000 in today's dollars (adjusted for inflation)! For the above reasons, Traditional IRAs and Roth IRAs, especially those owned by the student, can function as multi-purpose funding vehicles.

UTMA/UGMA accounts

Uniform Transfers to Minors (UTMA) and Uniform Gifts to Minors Act (UGMA) represent custodial savings accounts that are often set up for minor (underage) children. Custodial savings accounts will be set up under either UTMA or UGMA rules, depending on the minor's state of residence.

Operational flexibility: These accounts can be set up at either a bank or brokerage account. However, they are not as flexible as CESAs or 529 College Savings Plans in that beneficiaries of custodial accounts cannot be changed after the accounts have been created and funded, since the initial gift to the child is considered irrevocable.

Distributions from an UTMA/UGMA account can be made to either the beneficiary or account owner. The distributions must be made for the benefit of the child beyond what would normally be provided by parents/guardians.

Depending on whether the account was created as an UGMA or UTMA, along with each state's age of majority, will dictate when the child takes control of the funds. See the chart below for more information[5].

[5] www.finaid.org

	UGMA	UTMA	UTMA supersedes UGMA (*)
Alabama	19	21	10/1/1986
Alaska	18	21	1/1/1991
Arizona	18	21	9/30/1988
Arkansas	21	21	3/21/1985
California	18	18	1/1/1985
Colorado	21	21	7/1/1984
Connecticut	21	21	10/1/1995
Delaware	18	21	6/26/1996
District of Columbia	18	18	3/12/1986
Florida	18	21	10/1/1985
Georgia	21	21	7/1/1990
Guam	21	N/A	N/A
Hawaii	18	21	7/1/1985
Idaho	18	21	7/1/1984
Illinois	21	21	7/1/1986
Indiana	18	21	7/1/1989
Iowa	21	21	7/1/1986
Kansas	18	21	7/1/1985
Kentucky	21	18	7/15/1986
Louisiana	18	18	1/1/1988
Maine	21	18	8/4/1988
Maryland	18	21	7/1/1989
Massachusetts	18	21	1/30/1987
Michigan	18	18	12/29/1999
Minnesota	18	21	1/1/1986
Mississippi	21	21	1/1/1995
Missouri	21	21	9/28/1985
Montana	18	21	10/1/1985
Nebraska	19	21	7/15/1992
Nevada	18	18	7/1/1985
New Hampshire	21	21	7/30/1985
New Jersey	21	21	7/1/1987
New Mexico	21	21	7/1/1989
New York	18	21	7/10/1996
North Carolina	18	21	10/1/1987
North Dakota	18	21	7/1/1985
Ohio	18	21	5/7/1986
Oklahoma	21	18	11/1/1986
Oregon	21	21	1/1/1986
Pennsylvania	21	21	12/16/1992
Rhode Island	21	21	7/23/1998
South Carolina	18	N/A	N/A
South Dakota	18	18	7/1/1986
Tennessee	18	21	10/1/1992
Texas	18	21	9/1/1995
Utah	21	21	7/1/1990
Vermont	21	N/A	N/A
Virgin Islands	21	N/A	N/A
Virginia	18	18	7/1/1988
Washington	21	21	7/1/1991
West Virginia	18	21	7/1/1986
Wisconsin	18	21	4/8/1988
Wyoming	18	21	5/22/1987

Investment flexibility: Investment options for custodial accounts are determined according to the applicable state law and whether the accounts were set up under UTMA or UGMA statutes. For UTMA custodial accounts, funds can be invested in virtually any asset, while for UGMA custodial accounts, funds can only be invested in bank deposit accounts, securities, and insurance products.

Tax efficiency: UTMA/UGMA custodial accounts benefited from tax efficiency before the "Kiddie Tax" rules were in place, and since the recent passage of the TCJA, the tax benefits have become far less attractive. Essentially, any investment returns (interest, dividends, capital gains) generated within UTMA or UGMA custodial accounts are only partially taxed at the child's tax rate. The "Kiddie Tax" rules do protect some income, but only the first $2,100 of unearned income (the first $1,050 is tax-free and the next $1,050 is taxed at the child's marginal tax rate), while the remaining unearned income will be taxed at the trust and estate tax rate levels. As a result, these accounts are not going to receive tax-efficient treatment for most clients with children who have unearned income above $2,100. It is important to remember that the "Kiddie Tax" calculations become even more complicated if the child receives a combination of interest income/non-qualified dividends along with qualified dividends/long-term capital gains, and also if the child has earned income. Incorporating these additional factors and circumstances are beyond the scope of this guide.

Financial aid efficiency: UTMA/UGMA custodial accounts receive the worst treatment from a financial aid efficiency standpoint, since these accounts are considered student assets, which are assessed less favorably (higher rate) than parent assets in the financial aid formula.
UTMA and UGMA accounts are typically not the best education funding vehicles for families that are likely to qualify for financial aid, due to their high asset assessment rate (20% - 25%). Therefore, your most common approach to these accounts will be working with clients to get assets out of them rather than focus on putting assets into them. In chapter 4 on education planning for high net worth and high income individuals, some planning strategies that can be used to shift income-producing assets to children who hold these accounts to benefit from lower effective tax rates will be discussed, along with how you can navigate around the "Kiddie Tax" rules in certain scenarios.

PLANNING TIP: Planning with multiple children
If your client has more than one child and there is more than a four-year age difference between the children, consider transferring assets that are likely to be used for future college funding purposes for the younger child (not currently enrolled in college) to an UTMA/UGMA custodial account. These assets will not be reported on the oldest child's financial aid form, assuming he or she will be looking at FAFSA only schools since sibling assets are not reported on the FAFSA but are on the CSS Profile.

Prior to the base financial aid income assessment year for the younger children, liquidate the investments held in these accounts so there is no major financial aid impact. Prior to filling out the financial aid forms for the younger children, transfer these assets into a Custodial 529 College Savings Plan.

Custodial 529 College Savings Plans are more restrictive than Traditional plans but are still counted as parent assets (5% - 5.6%) for financial aid purposes.

This planning strategy will not likely be used by many due to the complexity of its coordination and the low assessment rate imposed on assets in the financial aid calculations; however, it is still worth mentioning because of the potential income tax savings that can be generated even with the "Kiddie Tax" rules in place.

UTMA/UGMA final takeaway

Make sure your clients act quickly with regard to these UTMA and UGMA accounts so that any income tax or financial aid implications can be mitigated before the base financial aid income assessment year passes and the financial aid filing deadlines are upon them.

Actual Client Story

The Smith family started talking about college planning with their CPA right around the time the son was finishing up the fall semester of his junior year in high school. When the CPA asked the clients if they had saved anything for college thus far, the parents explained that they had been saving in an UTMA account for the child. When the CPA inquired if they had ever considered saving in a 529 College Savings Plan, it was revealed that they were instructed "incorrectly" by an adviser years ago that funds in a 529 College Savings Plan must be used exclusively for college expenses and that the funds would be inaccessible for any other purpose. While the good news was that the student was at the top of his class based on both GPA and SAT scores, the family did themselves a disservice by investing a substantial amount of money into Apple Inc. stock held within the UTMA account, which eventually grew to be worth $130,000. Not only did the value of this UTMA custodial account diminish the family's ability to qualify for need-based aid, the stock within the account had a low-cost basis, so simply liquidating the account and transferring the funds to a Custodial 529 College Savings Plan would only have been a more advantageous financial aid planning strategy if it occurred prior to the base income assessment year. While at the end of the day, the student was able to qualify for a full-ride scholarship to a flagship state university, the student had also been accepted at several Ivy League institutions that would likely have awarded need-based aid, had the family been advised in their best interest from the beginning or had they talked about college planning with their CPA sooner.

Taxable investment accounts

Taxable investment accounts are among the most flexible, easy to setup, and easy to use savings vehicles for clients. However, they are often overlooked by many advisors when evaluating which savings vehicles to use for college funding.

Operational flexibility: These accounts are extremely flexible from an operational standpoint. Taxable investment accounts can be set up at bank or brokerage account. Distributions from these accounts will be made to the account owner.

Investment flexibility: Taxable investment accounts are extremely flexible when it comes to what the funds can be invested in, such as stocks, bonds, CDs, mutual funds, ETFs, etc. They also benefit from not imposing any funding or AGI limitations; however, it is more likely that underfunding will be the problem for most clients.

Tax efficiency: Unfortunately, there are no major tax benefits afforded to these accounts on either the contribution or distribution side of the equation. With that in mind, if you are also providing investment management services for your clients, you need to make sure you are recommending tax-efficient investments for these taxable accounts. This ties back to making sure your clients are focused not only on asset diversification and asset allocation, but also on the importance of asset location.

Financial aid efficiency: From a financial aid efficiency standpoint, taxable investment accounts will be considered assets of either the student or parent depending on who actually owns the account. If the account is owned by the student, similar to the UTMA/UGMA Custodial Accounts, it will be assessed less favorably than if it was owned by the parents.

What about joint accounts owned by the student and parent?
Joint-accounts are assessed as 50% student assets and 50% parent assets, even though with a joint account either party is able to access and/or fully deplete the entire account balance at any point in time.

PLANNING TIP: One is the loneliest number
Even though taxable investment accounts may be overlooked by your clients, they can end up filling the gap when the benefits of other savings vehicles have been maximized to their optimal efficiency and effectiveness.

Example

After running a funding analysis, it has been determined that your client needs to save $18,000 per year to achieve their education funding goal. Instead of solely investing the full $18,000 in a 529 College Savings Plan, you might consider recommending to the client that they fund the 529 College Savings Plan up to $10,000 this year since that will provide them with the maximum state income tax benefit (assumed in this case), and then they can utilize a Roth IRA, CESA, and/or taxable investment account for enhanced investment flexibility, tax efficiency, and risk reduction.

Just as diversification across different asset classes can help maximize investment returns while reducing risk, utilizing a combination of the aforementioned savings vehicles can help:

- Diversify risk
- Enhance flexibility
- Minimize taxation
- Optimize returns

Summary of education funding formula process

Education funding formula process

Project the Cost of College in the Future			
Time Horizon	Inflation	Current Cost	Years in School

↓

Determine Initial Target Savings Amount			
Funding %	Time Horizon	Rate of Return	Savings Frequency

↓

Analyze Current Cash Flow			
Cash Inflows	Cash Outflows	Reduce Spending	Lifestyle Alteration

↓

Determine Adjusted Target Savings Amount			
Funding %	Time Horizon	Rate of Return	Savings Frequency

↓

Determine Best Savings Vehicles			
Operational Flexibility	Investment Flexibility	Tax Efficiency	Financial Aid Efficiency

↓

Constant and Clear Communication			
Parents/Grandparents	Students	Accountants/Advisers	Guidance Counselor

Appendix: College Funding Checklist

Step 1: Run time value of money calculations to determine initial target savings goal (use of financial planning software or Excel is recommended).

- Determine COA for 4 colleges in today's dollars (Public and Private)
- Determine education inflation rate (3%-6%)
- Determine amount already saved for college (current 529 College Savings Plan balance)
- Determine whether funding will take place through age 22 (end of college) or until 18 (beginning of college)
- Run calculations to determine target savings needed to fund 25%, 50%, 75%, and 100% of the initial education goal to better illustrate how close the client is to achieving different iterations of this goal

Step 2: Run a cash flow analysis to determined what the family can actually afford to save according to the appropriate frequency (monthly, quarterly, annually).

- Evaluate opportunities to increase income or cash inflows such as taking on a second job/side hustle
- Evaluate opportunities to decrease cash outflows such as reducing or eliminating discretionary spending within reason
- Help manage the client's expectations by pointing out that this analysis does not factor in financial aid they may qualify to receive in the future

Step 3: Once the final target savings goal has been determined, evaluate the best savings vehicles to use:

529 College Savings Plans	
When to Utilize:	~ State tax deduction for contributions available ~ Low fee investment options available within plan
What Type of Plan:	~ Direct-sold plan(s) available
Best for Which Clients:	~ Clients with moderate or high AGI and grandparents
Taxable Investment Accounts	
When to Utilize:	~ Utilize in conjunction with 529 College Savings Plans
What Types of Investments:	~ Tax-efficient (geared towards capital appreciation)
Best for Which Clients:	~ Clients who have maxed out 529 contributions for state income tax purposes
Roth IRAs	
Best for Which Clients:	~ Clients below the AGI phase-out range ~ Students with earned income
Planning Pitfalls:	~ Timing of distributions is critical since they will impact need-based aid calculation (reserve for Junior and Senior Year qualifying expenses)

Step 4: Provide recommendations in a report based on discussions with client and analysis findings.

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