NELSON ROBERTS
INVESTMENT ADVISORS

WEALTH MANAGEMENT

GUIDE TO EDUCATIONAL SAVINGS

There is no denying the importance of your children's college education. But with the average cost of a private four year university currently nearing $200,000 (including room and board) and increasing over 3% per year above inflation*, the cost of a college education for a child born today could exceed $350,000. This dramatic rise highlights the importance of planning for these expenses.

There are a number of vehicles you can use to save for children's college education and a number of factors to determine which is best for you and your family.

529 Plans

529 plans are educational savings plans designed to help parents save for their children's education. Every state offers a 529 plan, however, you are not restricted to using the one offered by your state. Fees and investment options vary by plan so it is important to research before deciding which plan to use. All 529 plans will have an owner – generally a parent or grandparent– and a beneficiary – generally a child.

Contributions to 529 plans are treated under the federal gift tax rules which allow you to contribute $15,000 (in 2018) a year to the account without incurring a federal gift tax. Some states offer tax incentives for contributions although California does not. There is also a special election you can make to lump 5 years' worth of gifts into one year. This means you and your spouse are able to contribute $75,000 each ($150,000 total) to a 529 plan in one year. These contributions are considered completed gifts from the donor to the beneficiary making this an effective tool to transfer wealth. However, if you die before the 5 year period is up, the portion of the contribution allocated to the years after your death will be included in your estate.

The major advantage of 529 plans is that the funds grow tax deferred and withdrawals are tax free if used for education. The new tax code expanded the use of 529 plans to include up to $10,000 for tuition for elementary or secondary public, private or religious schools. However, if the funds are not used for education, there is a 10% penalty and all growth is subject to taxes. If the named beneficiary does not end up needing all of the funds in the account, the beneficiary may be changed to another qualified family member.

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Uniform Transfer to Minors Act

Another option which gives more freedom for how the assets are used is a Uniform Transfer to Minors Act or UTMA. This is sometimes referred to as a custodial account as it requires an adult custodian to be on the account until the child reaches the age of majority which is 18 or 21 in most states.

UTMAs are not tax deferred accounts so income generated from the investments is taxable. The Tax Cuts and Jobs Act changed the Kiddie Tax rules so that a child's investment income in excess of $2,100 is taxed at the rates for trusts and estates.

*According to the College Board

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These tax brackets are much more compressed than those for individuals or couples showing the advantage of using a tax deferred account like a 529 plan. However, UTMAs have no penalty for using the funds for non-educational expenses giving the child more options.

Once the child turns 21, the funds in the account are legally theirs. This may be a drawback if the child is not mature enough to handle the assets at that age. The gift you hoped they would use to invest in their education could be blown on a car or spent frivolously.

2018 Ordinary Income Tax Rates for Trust and Estates	
10% Bracket	$0-$2,550
24% Bracket	$2,551-$9,150
35% Bracket	$9,151-$12,500
37% Bracket	$12,501 and above

2018 Long Term Capital Gains and Qualified Dividend Rates for Trust and Estates	
0% Bracket	$0-2,600
15% Bracket	$2,601-$12,700
20% Bracket	$12,701 and above

Irrevocable Trusts

For more control over the assets, parents can set up an irrevocable trust and dictate when and how the funds are distributed to their child. It is even possible to have partial distributions at different stages in life. For example, assets can be distributed to them when they graduate from college, turn 25 or 30, or get settled in their career. This can be an effective tool to protect what can grow to be a substantial account from a spendthrift child.

Creating a trust requires a trust document to be drafted by an attorney and a separate tax return each year (taxed at the above tax rates) making it the most costly option. However, irrevocable trusts provide an interesting estate planning opportunity.

A client was facing an estate tax liability and looking to lower their taxable estate. We advised they open irrevocable trusts for each of their children and utilize the annual gift tax exclusion to fund the trusts each year. Once their children were entering college, the client could also pay for tuition and expenses which are exempt from gift taxes. Therefore, they were able to reduce the size of their estate by both the gifts and education costs.

After the children had graduated, the assets in the trust were available to them when the trust document stipulated they be distributed. The mature children were then able to use the funds to put down payments on houses and start families of their own.

So what is the best option for you and your children? It depends on your family, your goals and your estate size. In some cases, it may make sense to have more than one type of account. If you would like more information on educational savings and estate tax mitigation techniques, please contact us.

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