Saving for college

Congratulations, you have been accepted!

As high school seniors all over the country are sorting through their college acceptance letters, their parents and grandparents are feeling trepidation about covering tuition, room and board, and other expenses for the next four years. They are not alone! With average tuition rates growing at 2–4% per year,[1] the cost of college has become a daunting consideration. Active early planning and some creativity can help position your family to be financially well-prepared to send the next generation off to college.

At Mesirow, we work with families to create comprehensive financial plans, across generations, that help prepare for pivotal life events like college. A 529 college funding plan is one example of a solution that we thought you might want to learn more about.

Created in 1996, 529 plans have grown significantly in popularity and are a mainstay of funding college education expenses, as well as a vehicle for multi-generational planning.

529 plan overview

A 529 plan is a state-sponsored savings vehicle specifically aimed at covering qualified education expenses at post-secondary institutions, from college through graduate school. Each 529 plan has an owner (frequently the parents or grandparents) and a beneficiary (the individual who will use the funds to cover “qualified education” expenses). Contributions to a 529 plan are:

- Made with after-tax dollars (at the Federal level)
- Grow tax free over time
- Can be withdrawn tax-free in order to pay for qualified education expenses.

Qualified education expenses

Qualified education expenses include:

- Tuition and fees
- Books, supplies, and equipment, if required by the educational institution
- Computer or peripheral equipment, computer software, or internet access and related services are considered qualified education expenses “if it is to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution.”[2]

View more details regarding qualified educational expenses.

State laws can impact your decision

Some states offer a state income tax benefit for contributing to the state-specific 529 plan. For example, Illinois allows residents to deduct up to $10,000 annually for state income tax purposes by contributing to one of the two state-offered 529 plans ($20,000 for a married couple).

Benefits of a 529 plan versus an UTMA or UGMA

Custodial accounts established through the Uniform Gift to Minors Act (UGMA) or the Uniform Transfer to Minors Act (UTMA) can be very effective tools for passing assets to the next generation, however they can have some unintended consequences that 529 plans do not have:

- At the age of 18 or 21, depending on the state of residence, the assets in an UTMA or UGMA pass directly and outright to the beneficiary. If you are concerned about your child or grandchild having direct control of assets at a young age, an UTMA or UGMA may not be the right vehicle to fund.
- UTMAs and UGMAs do not have the same tax benefits as 529 plans and can trigger capital gains or income taxes for the child. Being aware of the “Kiddie Tax” rule is important as minors pay income tax at their parents’ rates beyond the first $2,500 of annual income earned in their UTMA/UGMA.

Both 529 plans and UTMAs/UGMAs are subject to the standard annual gift exclusion of $18,000 per year per donor ($36,000 for married couples). However, 529 plans are eligible for “superfunding” as described in the following section.

529 plans and family college planning

529 plans have unique characteristics that allow for dynamic family planning.

- The owner of the 529 plan can reassign beneficiaries within the same family without any gift tax consequence. For example, if you open a 529 plan for three siblings, and one gets a full scholarship to college, you can change the beneficiary on his or her account to the other two siblings, or even a first cousin, to more fully fund their educations.
- 529 plans allow for “superfunding,” a term used to describe the special 5-year gift-tax election described in section 529(c)(2)(B) of the Internal Revenue Code. “Superfunding” allows the donor to a 529 plan to give up to five years of contributions in a single year, allowing a lump sum contribution of $90,000 from an individual or $180,000 for a married couple without creating a taxable gift.

Individuals who are seeking to remove assets from their estate can use this technique to make significant gifts to the next generation. The older generation also would have the opportunity to pay for college expenses directly and maintain “superfunded” 529 balances for future generations.

Whether the young people who are most important in your life are 18 months old or 18 years old, the 529 plan can be a very powerful tool for future college and multi-generational planning.

Our clients entrust us to be educated stewards of their accumulated wealth. We value this responsibility and constantly strive to help families make informed decisions across generations about important milestones in life, like a college education. Please let us know how we can help your family.

[1] Source: College Board

[2] Source: IRS.gov

Before investing in an "out-of-state" 529 college savings plan review the potential other benefits that may be provided by investing in a 529 college savings plan offered by the home state of the investor or of the designated beneficiary. Those benefits may include financial aid, scholarship funds, and protection from creditors.

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