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Introduction

Paying for college has become increasingly burdensome for American families, often saddling unprepared graduates and parents alike with high levels of student loan debt. While these issues alone are problematic, their impact on the overall financial security of American households has become even worse as families struggle to balance college costs and debts with the need to save for retirement.

These weren’t always competing imperatives. But the relentless increase in college tuition over the past two decades has coincided with a dramatic change in our nation’s private retirement system. Years ago, many employers paid all the costs of providing their workers with traditional, defined benefit pension plans. Today most do not, offering instead 401(k) plans that place much of the burden of saving for retirement on employees. The ironic upshot is that while saving for college has become even more important than it used to be, doing so now makes it that much harder to save for retirement.

To be sure, many financial advisors argue that this is a black-and-white issue: Parents should prioritize saving for retirement over saving for college. After all, families can borrow for college but not for retirement. On the other hand, parents may be able to delay retirement if they haven’t saved enough money to stop working, but typically cannot delay, to any significant degree, a child’s college education.

As shown in Figure 1, the inflation-adjusted cost for both four-year public colleges and private colleges has doubled over the last 20 years.

To appreciate just how big the college savings challenge has become, consider that the cost to attend an elite private college during the 2018–2019 school year commonly exceeded $71,000.1 Assuming 3% inflation, this means the projected cost for one of these schools will exceed a half million dollars for a child born today. See Figure 2.

Anyone who thinks a public university will be significantly more affordable should reconsider. Even at a top public college, an out-of-state student spent nearly $70,000 on room, board and tuition for the 2018–2019 school year.2

Even a far less expensive in-state college charging $20,000 annually can present a daunting financial challenge for many families. Again assuming a 3% annual rate of inflation, sending today’s newborn to that “bargain” school will cost more than $140,000.

More than ever, then, families who wish to give their children as much financial assistance as possible for college, and the greatest possible range of choice in where they go to school, must not only save a substantial sum of money but also invest it wisely.

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1 For example, University of Notre Dame average cost of attendance for 2018–2019 is $71,801. https://admissions.nd.edu/discover/cost-financial-aid/

2 For example, University of Virginia estimated undergraduate cost of attendance for 2018–2019 exceeds $70,000 in many of its schools for out-of-state students. https://sfs.virginia.edu/cost/18-19
That means minimizing taxes while maximizing potential investment returns, all while taking an appropriate amount of risk.

Families that don’t do that will have to borrow the necessary funds, with interest payments starting either as soon as the money is borrowed or when the student graduates, depending on the type of loan.

Save or borrow, that can make for an uncertain outlook. No one can know for sure, after all, how the financial markets will perform in the future. Nor can anyone know for sure what the interest rate environment will be when their child attends college years from today. It is worth noting, however, that after being at or near historic lows for years, short-term interest rates have started to tick up. The upshot? Just as the risk of not having enough funds to pay for college is increasing, so is the cost of borrowing to make up the difference.

On the plus side, the Tax Cuts and Jobs Act of 2017 lowered federal income tax rates, leaving many families, at least for now, with more take-home pay. That may make it a bit easier for some to save for college.

This guide describes a range of college savings and investment vehicles that are commonly available to families. Importantly, it also describes a wide range of tactics, some of which receive little public attention, that students, parents and grandparents may be able to employ to help them reach their college savings goals.
While there are a number of vehicles available to save and invest for college, most parents will be wise to focus on tax-advantaged options such as 529 plans, Coverdell Education Savings Accounts, and IRAs. 529 plans provide contribution flexibility and have high contribution thresholds with no income limitations. Coverdell accounts, by contrast, are limited to families with household income below a certain level, and also limit annual contributions—to $2,000 per beneficiary. IRAs are also a viable option which can provide tax favored savings that are exempt from the 10% penalty tax when used for education costs for your child. And, any unused savings can be used to benefit your retirement.

529 Plans

Also known as qualified tuition programs, 529 plans are available in two forms: savings plans and prepaid plans.

- Savings plans are by far the most popular type of 529 plan. Contributions are invested in the financial markets, and the accumulated wealth can then be withdrawn for qualified education expenses on behalf of the designated beneficiary—usually a child or grandchild, although any adult can set up a 529 account for themselves, too. Savings plans can only be offered by states.

- Prepaid plans allow families to pre-pay all or some of the cost of attending a college in advance. Both states and colleges can offer prepaid plans, although right now there is only one college-sponsored plan, the Private College 529 Plan.
Both savings plans and prepaid plans offer valuable tax benefits: Investment earnings are exempt from federal income taxes, and often from state and local taxes as well.¹

Since savings plans are much more popular and flexible than prepaid plans, all further references to 529 plans in this guide will be to savings plans unless otherwise noted.

When investing in a 529 plan, anyone who has ever participated in a 401(k) or similar defined contribution retirement savings plans will find the process familiar. Most 529 plans offer a varied menu of investment options, including actively and passively managed mutual funds, exchange-traded funds (ETFs), and, in some cases, stable value funds. Often, the investment lineup will include age-based funds that are similar to the target-date funds found in most 401(k) plans. Age-based funds invest more aggressively when the beneficiary is younger, and gradually and automatically invest more conservatively as the child nears college age. Savings plans do not offer the ability to invest in individual stocks.

The biggest advantages of 529 plans over other college-savings vehicles are that their investment earnings are not taxable while an account is growing, and all withdrawals, when made for qualified education expenses, are tax-free at the federal level. In some states, withdrawals are tax-free at the state level, too. Contributions are not tax-deductible at the federal level, but are deductible in some states at the state level.

Investing in a 529 plan does not dramatically impact a child’s ability to qualify for financial aid. That’s because the Federal Methodology for determining need only counts up to 5.64% of any 529 account balances owned by a parent or child. What’s more, if the student owns the 529 account but is a dependent, the money in the 529 account is considered an asset of the parents, not the student. The Institutional Methodology, which some private colleges use to determine need-based financial aid, measures 529 plan assets in a similar way.

States can and often do offer more than one 529 plan, some of which are sold through advisors and some of which can be accessed directly by investors, often at a lower cost. Families can invest in any plan they like, not just those offered in their own state. They also can invest in as many 529 plan accounts as they wish, which, as we will discuss later, can be advantageous under some circumstances.

Ownership of a 529 account can be changed after the account has been established, which can be useful for some college savings strategies that will be discussed later in this paper. Most 529 plans also allow the owner to change the beneficiary of an account, which again can be useful under certain savings strategies to be discussed.

529 plans do have some investment restrictions that other investment vehicles—notably IRAs—do not. Owners can only change the investments in their 529 plans twice per year, for example. And while they can transfer 529 accounts between different states’ plans, they can do so only once in any 12-month period. Finally, many 529 plans limit contributions after account balances reach a certain amount (e.g., $400,000 in the state of Colorado). Some also limit the annual contribution, often to the annual federal tax-free gift amount, which is currently $15,000 per person per beneficiary. That said, once a limit is reached, nothing prevents a parent or grandparent from opening a separate 529 plan to make additional contributions.

Despite the many advantages that 529 plans offer, only 18% of families paying for college during the 2017–2018 academic year used them.²

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¹ FinAid, http://www.finaid.org/savings/529plans.phtml
Coverdell Accounts (ESAs)

Coverdell Education Savings Accounts, or ESAs, are similar to Roth Individual Retirement Accounts (Roth IRAs). The biggest difference is that ESAs are intended for college expenses rather than retirement. As with 529 plans, contributions to ESAs are not tax-deductible, but earnings grow tax-free until they are distributed. Also as with 529 plans, withdrawals from ESAs, including investment earnings, are not taxable if used for qualified higher education expenses.

Any individual whose modified adjusted gross income is below $110,000 ($220,000 for a joint return) is eligible to contribute to an ESA. Parents in that income bracket can contribute up to $2,000 per year per beneficiary to an ESA. For parents earning between $95,000 and $110,000 ($190,000 and $220,000 for married couples), the $2,000 limit for each beneficiary is reduced. Neither the contribution limit or income limits are indexed for inflation.

Due to these relatively low contribution limits, most families will prefer 529 plans over ESAs. Technically, however, families may contribute to both a 529 plan and ESA in the same year if their income is below the ESA limits.

Individual Retirement Accounts (Traditional and Roth)

For 2019, contributions to either a traditional IRA or Roth IRA can be made up to $6,000 annually for those under age 50 and $7,000 for those age 50 or older. Withdrawals from either type of IRA can be made tax-penalty free at any time when used for college expenses.

Parents who are not covered by a retirement plan at work can fully deduct their traditional IRA contributions. Parents who are covered by a retirement plan at work may be able to take a full or partial deduction depending on their income. Withdrawals of pre-tax contributions and earnings from a traditional IRA are taxed as ordinary income.

Contributions to a Roth IRA are made on an after-tax basis and earnings in the account grow tax-free—just like with 529 plans and ESAs. For someone under the age of 59½, money contributed to a Roth IRA can be withdrawn tax-free. The earnings would be taxable but would be tax penalty-free if used for higher education expenses. Assuming the account has been open at least five tax years, all withdrawals would be tax-free and tax penalty-free once the individual reaches age 59 1/2.

Federal Versus Institutional Methodology

Need-based financial aid for college is awarded based on a family’s income and assets. Colleges typically employ one of two methodologies for calculating whether a student qualifies for need-based aid, the Federal Methodology or the Institutional Methodology. The Federal Methodology is used by the federal government, all public colleges, and many private colleges. This methodology requires the submission of the Free Application for Federal Student Aid (FAFSA). Meanwhile, more than 200 private colleges use the Institutional Methodology to determine whether students are eligible for non-governmental financial aid they issue directly, including grants, loans, and scholarships. The Institutional Methodology gives colleges some flexibility in how they treat certain income and assets, which means that not all colleges using this methodology will award financial aid the same way. To apply for need-based aid to schools employing the Institutional Methodology, families must complete the College Scholarship Service Profile (CSS Profile).
Since earnings cannot be withdrawn from a Roth IRA prior to age 59½ without paying taxes, parents who will be under that age when their child is in college will likely be better off investing in a 529 plan. That said, if a parent is really unsure about whether a child will attend college or not, but wishes to put money aside just in case the child attends, they could be better off using an IRA (traditional or Roth). If the assets are not used for a child’s college education, they could be used instead for the parent’s retirement.

Whether using a traditional IRA or Roth IRA is best depends on the parents’ current and expected situation. Items to consider include current and expected retirement income brackets, the parent’s age when withdrawals would be needed and the potential impact on taxation of Social Security benefits.

Families applying for financial aid under the Federal Methodology (See Quick Tip 1) will want to keep in mind that IRAs are not reported as assets on the Free Application for Federal Student Aid form (FAFSA). However, distributions will be counted as either taxed or untaxed income for the student, so it may be best to wait until the student’s junior or senior year to use IRA assets. (In determining eligibility for aid, the Federal Methodology looks back not at the year prior to the school year, but the year before that—the prior-prior year. Accordingly, assets used in the junior or senior year will typically never count as income for this purpose.)

Depending on the institution, both IRAs and ESAs can be invested in mutual funds, ETFs, individual stocks, and other types of investments.

### Other Potential Investment Vehicles

A number of other types of investment vehicles can be used to save for college, including mutual funds and bank certificates of deposit (CDs). Those two vehicles generally don’t offer the tax advantages of 529 plans or ESAs, but they are a bit more flexible. Money invested in them can be used for college, yes, but also for anything else the account holder may wish to spend it on.

Other options include custodial accounts, such as those that can be created under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). Because they do not offer the same tax advantages as 529 plans—or ESAs, for that matter—UGMA and UTMA accounts were more popular before 529 accounts were introduced in 1996. UGMA and UTMA accounts also suffer by comparison because assets held in them are considered the child’s, which means that any income they generate above a small threshold is subject to the so-called “Kiddie Tax.” The Kiddie Tax, which is now calculated using the tax brackets that apply to trusts, applies even to college students if they aren’t providing over half their support from their own income. Finally, assets in custodial accounts are available to the child without restriction when he or she turns a certain age, which can vary depending upon the state and type of account but in most cases is either 18 or 21. This raises the possibility that the child could use the money for something other than educational purposes.

Permanent life insurance is yet another product that can be used as an investment vehicle, but it typically comes with higher built-in expenses than 529 plans or ESAs due to the death benefit it offers. That said, with the increasing cost of college, life insurance coverage can be more valuable than ever if a parent dies prior to reaching a college savings goal. (See Quick Tip 2.)

While it may appear obvious, families should keep in mind that it is much harder to achieve their college savings goals if they are paying more taxes than necessary by using the right savings vehicles.
Tips and Tactics for Parents to Maximize College Savings

The most important actions parents can take to reach a college savings goal are to start early, automate regular contributions into a tax-preferred account through payroll deduction or bank transfer, and adopt an appropriate investment strategy. Since the cost of college will be so expensive, parents also need to think hard about how comfortable they are with taking investment risk. Understanding their risk tolerance will help them settle on the optimal investment strategy for them.

Risk Management: The Conventional Approach

Many 529 plans provide age-based funds that automatically invest more conservatively over time as the beneficiary gets older. Some of these funds are further broken down into ones that invest more aggressively, moderately aggressively, or less aggressively, allowing account owners to choose which aligns best with their tolerance for risk. Alternatively, plan owners can forgo age-based funds and choose a static portfolio whose investment approach aligns with their tolerance for risk. With a static portfolio, the investment allocation will not become more conservative over time.
Why the Conventional Approach Might Not Be Optimal

Although the cost of attending college creates a huge financial challenge for many parents, so do the uncertain prospects for investment returns. Stock market returns can be volatile, especially over shorter time horizons like those facing many parents in their quest to save and invest for college. Meanwhile, bond funds can be volatile as well, especially in a rising interest rate environment.

So, while a conventional approach to saving and investing for college will work for many parents, other strategies may provide opportunities for better results. This paper identifies seven such approaches. Note that the first two may encourage parents to invest more aggressively than they otherwise might due to the ability to be flexible when the time to pay for college approaches. Note, too, that there is always the chance that engaging in a riskier investment strategy will not pay off, in which case families could end up paying more out of pocket for college than they expected.

Tactic 1
Create Multiple 529 Accounts Spanning Multiple Children

If parents have more than one child, one way to potentially boost realized investment returns is by opening multiple accounts for each child using a variety of investment strategies, then taking withdrawals opportunistically depending on which strategies perform best earliest. With this approach, college investing is thought of in the aggregate across all children, not just on a child-by-child basis.

Consider a family with two children destined for college: Alex and his younger brother Zeb. Rather than follow conventional strategy—investing in one age-based fund for Alex and another for Zeb—their parents invest in two different 529 plans in two different states for each child, creating a total of four accounts. For each child, the parents invest one account in equities (stocks) and the other in bonds. Then, the parents view the four accounts as one big pot of money to be tapped in whatever order proves most advantageous, knowing they can switch beneficiary designations for each account between the two boys if needed.

With this freedom, the parents decide to invest more aggressively with Alex’s equity account, and/or to allocate more money to it than to his bond account. They are comfortable doing this, even though they may be investing more aggressively than their tolerance for risk would normally allow, because they also have access to both Alex’s bond account and Zeb’s bond account. If Alex’s stock account is down due to a bear market when it’s time for him to go to college, his parents can make him the beneficiary of Zeb’s bond account and use that to help cover Alex’s college costs. Meanwhile, they can leave some or all of Alex’s stock account untouched while they give the stock market time to recover. Later, when it’s Zeb’s turn to start college, the parents can make Zeb the beneficiary of Alex’s stock account and use it to help pay for Zeb’s college costs.
Tactic 2
Consider an IRA as a Potential Source of Funds and Go Aggressive

This tactic is aimed primarily at older parents. As mentioned earlier, IRA assets are generally more valuable to older parents as a college savings vehicle because it is only at age 59½ and beyond that funds can be withdrawn generally tax penalty-free. Accordingly, parents who will reach that age within a few years of their child graduating from college may wish to use an IRA to save for that expense. When their child enters college they can take out short-term loans to pay the expenses. Loans are not income for FAFSA purposes. Then when the student is in the last 2 years of college or upon the parent turning 59½, if later, they can use the IRA to repay those loans without impacting the FAFSA calculations or incurring a tax penalty (while the funds taken out to pay the college expenses are not subject to tax penalty, the funds taken out to later pay loans related to college expenses would be subject to penalty unless another exception, such as turning 59½, applies).

One advantage to saving in an IRA is that its assets are considered retirement assets under both the Federal Methodology and Institutional Methodology for determining a student’s eligibility for financial aid, meaning those assets will not count against the student.

The main value of using an IRA rather than a 529 plan, though, is that the assets in the plan can be used for other purposes if it turns out they are not needed college expenses. They can be used to generate retirement income, for example, or left as a bequest at death after years of compounding earnings. Also, unlike retirement accounts funded with pre-tax dollars, Roth IRAs do not require their owners to take Required Minimum Distributions beginning at age 70½, which means they have excellent long-term growth potential.

The upshot of all this is that parents may wish to use an IRA for some of their college savings using a very aggressive investment approach. If investment returns are positive by the time the child enters college, the IRA can be used to pay for college expenses. If they are poor or negative, the assets can be left alone, given time to recover, and ultimately used for retirement. In the meantime, while their child is in college, parents can use current income they otherwise would have contributed to a 401(k) or similar retirement savings plan to pay college expenses.

As an example, assume Debbie needs to save $60,000 for her child’s college education. She also is contributing $20,000 annually to her 401(k). She saves for college through an IRA, investing a high portion in equities, but watches stocks enter into a bear market just before her daughter enters college. Her IRA is worth only $40,000, not the $60,000 she had hoped for. At this point, Debbie leaves her IRA untouched and reallocates $15,000 per year that was going into her 401(k) to pay for her daughter’s college. Debbie still contributes $5,000 annually to her 401(k) during the four years her daughter is in college, allowing her to continue receiving the maximum matching contribution provided by her employer. She still has assets invested for both college and retirement, she just adjusted which buckets she was using as the source of those assets.

Parents who are inclined to dismiss this strategy because they don’t believe themselves to be eligible to invest in a Roth IRA or make a tax deductible contribution to a traditional IRA will want to carefully review the next tactic, which explains how to contribute to Roth accounts in non-traditional ways.
Because parents can switch beneficiaries of a 529 plan between siblings, any 529 plan assets not used for an older child can later be used by a younger child. However, if the family’s youngest child doesn’t use all of those assets, any leftovers will be subject to a 10% tax penalty upon withdrawal, and all of the investment gains in the account will be taxed at ordinary income tax rates, too.

The good news is that the parents can use an IRA. When a family’s youngest child goes to college, his or her parents will be closer to the magical age of 59½. Given this, some families may wish to invest some of their youngest child’s college savings in an IRA or even an employer 401(k) as described in Tactic 2. This way, any money that is left over after paying college expenses can be used for other purposes. (A 401(k) is a workplace savings plan that works much like an IRA, but with higher contribution limits.)

There are unconventional ways to get more money into an IRA. Many employers offer a 401(k) plan to which employees can contribute on an after-tax basis (rather than the usual pre-tax basis). If someone is already maxing out their before-tax and/or Roth contributions, and still has funds to invest, they may wish to consider investing in the after-tax 401(k) portion of their plan, assuming it is offered. With after-tax contributions, (which are different than pre-tax contributions or Roth contributions), they can increase their 401(k) contributions beyond the $19,000 annual limit (for 2019), for those under age 50 ($25,000 for those age 50 or older). If they are 50 or older, the combined contributions from the individual and their employer, for pre-tax, Roth, and after-tax 401(k) accounts, is $62,000 in 2019.

If a plan participant will have separated from service prior to their child entering college, they can roll any after-tax 401(k) assets into a Roth IRA, and either roll the investment gains into a traditional IRA or pay tax at this point on the gains and include them in the Roth IRA rollover. Once inside the Roth IRA, subsequent investment gains grow tax-free. When the child is in college, withdrawals can be made tax-free and penalty-free if the Roth IRA owner has reached age 59½. To do this, their Roth IRA needs to have been in place for at least five tax years. To make use of this strategy, then, they will want to establish a Roth IRA early on, even if it only has a small amount in it, and even if they must do it by making a non-deductible, traditional IRA contribution and then converting it to a Roth.

Individuals who haven’t yet separated from service when their child enters college also have creative options for moving money into an IRA. If they have a 401(k), for example, they may be able to borrow from that account, pay themselves interest on the loan, and then, once they have separated from service, repay the loan to the plan or, by the time they file their tax returns, roll the loaned amount into an IRA. Once the loan has been repaid and the Roth balance has been rolled into a Roth IRA, they can immediately withdraw that money tax- and penalty-free if they have reached age 59½.
Here's an example. Jamie is 56 and planning on retiring from his current employer in four years. He borrows $50,000 (the IRS maximum) from his 401(k) account, paying himself interest for four years. When he retires in four years, he pays the balance of the $50,000 loan back or rolls the loan into an IRA. If the loan was from a Roth 401(k), the strategy would be to roll into an existing Roth IRA. Assuming a 7% interest rate on the loan, Jamie could save up to $3,500 annually in loan interest by paying himself interest in lieu of a bank. If the loan is not paid back, then Jamie is now over age 59½, so there is no tax penalty and the withdrawal from his 401(k) hits FAFSA income in later college years.

**Tactic 4**

**For High Schoolers, Consider a 529 Plan Offering a Stable Value Fund**

Families who have saved a significant amount of money to send a child to college typically cannot afford to lose any of it in the years immediately leading up to and through college. If interest rates rise, bond funds can lose value since newly issued bonds will pay a higher rate of interest than older bonds which were issued when interest rates were lower. Enter 529 plans that offer stable value funds. These funds, which are widely popular in 401(k) plans, guarantee both principle and interest.

Assume parents Dave and Laura have saved $200,000 for their 17-year-old daughter to attend a private college next year. They strongly feel they cannot afford to lose any of their $200,000 by investing in a bond fund that could go down over the next year—let alone in a stock fund. Instead, they transfer their 529 assets out of their current plan into one offering a stable value fund that will pay a guaranteed 2.50% “crediting rate,” or rate of return, over the next year. Dave and Laura are content to take all investment risk off the table and earn $5,000 in guaranteed interest over the next year, and likely similar amounts over the remainder of their daughter’s college years. (Some stable value funds reset their crediting rate at periodic intervals, although the crediting rate tends to fluctuate less than the returns on intermediate-term bonds, in which stable value funds mostly invest, thanks to credit-rate formulas that amortize differences between a fund’s book value and market value over time.)
Tactic 5

If Divorcing, Convert 401(k) Assets to Traditional IRA Assets and Be Selective on Schools

While 401(k) assets typically should be saved for retirement, there may be instances when a divorced individual wishes to use 401(k) assets received in a marital settlement for college expenses. The Tax Reform Act of 2017 makes this a more attractive proposition. Upon divorce and the execution of a Qualified Domestic Relations Order (QDRO), a spouse receiving 401(k) assets can roll them into a traditional IRA, where they can be used to pay for college expenses. The new tax law impacts this strategy two ways. First, not only have overall income tax rates been lowered, but for divorces occurring after 2018, alimony is no longer taxable. This means that a lower-earning spouse is not only no longer paying tax on alimony received, but also may see lower tax rates applied on their other sources of income. Therefore, taking a traditional IRA withdrawal may no longer create much, if anything, in the way of a tax bill. IRA withdrawals could, however, impact financial aid qualification if taken early in the child’s college career.

Divorced individuals also should keep in mind that many colleges, including some private colleges, only count the assets of the custodial parent when determining need-based financial aid. This is always the case when the college uses the Federal Methodology for determining need, and is also the case at colleges that use the Institutional Methodology but do not require information about the non-custodial spouse. Parents can find out which schools allow the non-custodial parent information to be initially ignored in the Institutional Methodology by visiting the College Board website at https://profile.collegeboard.org/profile/ppi/participatingInstitutions.aspx

Note that college expenses paid by a non-custodial parent on behalf of a student will count as non-taxable income to the student in an ensuing year. To avoid this, a non-custodial parent can pay expenses for the final two years of college and those monies will not count as income to the student. (Remember, the Federal Methodology looks back to the prior-prior year when tallying student income.) For the freshman and sophomore years, meanwhile, current income, 529 plan assets, and loans can be used as needed to fund college costs.
Parents who find themselves way behind on saving for college may want to consider allocating as much as possible into their 529 plans now, and then becoming a very conscientious college consumer by focusing on schools that offer what is known as preferential packaging. With preferential packaging, colleges offer a higher level of gift aid (grants and scholarships) than they typically might, depending on the desirability of the candidate.

While most of the elite private schools do not provide merit-based scholarships, a number of excellent private schools do offer merit-based packages to draw in students they want. Parents can find out which schools provide a significant amount of merit-based aid by visiting CollegeData.com and using its College Match application.¹

With preferential packaging, colleges offer a higher level of gift aid than they typically might, depending on the desirability of the candidate.

With the cost of a private college education at elite schools projected to reach half a million dollars when today’s newborns attend, starting saving and investing as early as possible is critically important. Prospective parents can get a big head start by opening a 529 plan and designating themselves as the beneficiary. Later, when they are having a child, baby shower gifts and other gifts can be made payable to the 529 plan account and immediately invested. Once the baby is born and receives a Social Security number, the beneficiary can be changed to the child.

To illustrate the potential benefits, consider a situation in which $5,000 in gifts is contributed to a 529 plan for an unborn child. This sum subsequently earns 7% annually. By the time the child is a college senior, she would have an additional $22,000 that could be withdrawn tax-free to pay for college expenses.

¹ CollegeData, https://www.collegedata.com/cs/search/college/college_search_tmpl.jhtml
Innovative Tactics Utilizing Grandparent Assistance

529 plans in most cases will be the optimal vehicle for grandparents to use to save and invest for a grandchild’s college education, whether the account is owned directly by the grandparent or a parent. Using the tax code’s annual gift tax exclusion, a grandparent could gift $15,000 to each grandchild beneficiary in 2019, while a set of two grandparents could gift $30,000 per grandchild.

Grandparents also can front-load 529 plan contributions by making up to five years’ worth of gifts in one year. For example, a single grandparent could gift $75,000 in 2019, while a set of grandparents could gift $150,000. The big advantage to this approach is that it leverages the tax-free nature of investment gains over time until they are used for educational expenses.

It’s important to note that for the grandparents’ tax purposes, these gifts do not count toward the lifetime exemption amount. Even if grandparents were to gift more than the annual exclusion amount, the excess would be applied to the lifetime exemption for gifts for federal income tax purposes—and this amount has increased to $11.4 million per individual, and $22.8 million for couples, under the Tax Cuts and Jobs Act. These amounts are for 2019, and are indexed for inflation thereafter. Hence, very few grandparents need worry about gift or estate tax implications when using 529 plans to contribute to a grandchild’s education.
Here are seven specific tactics grandparents may wish to consider:

**Tactic 8**

**Maximize Financial Aid by Transferring 529 Plan Ownership to a Parent**

If a grandchild is likely to be relying on financial aid to help pay for college, grandparents will want to be wise about how they utilize a 529 plan. If the plan is owned by the grandparent, the assets will not count against financial aid eligibility for the student under the Federal Methodology. However, withdrawals will count as untaxed income for the student in the year they are made. Therefore, grandparents may wish to use those assets in the child’s junior or senior year, at which point that income will not be factored into aid calculations. (As noted earlier, aid calculations are based on prior-prior year income.)

Alternatively, grandparents may wish to make periodic gifts to a 529 plan owned by the child’s parents. In this case, up to 5.64% of the 529 account assets would count in the financial aid calculation each year, but withdrawals would not count as student income.

Grandparents who have already set up a 529 plan with themselves as owners still have options for minimizing the impact on their grandchild’s financial aid. Since most state 529 plans allow a transfer of ownership of 529 accounts, they could save in the 529 plan they own, and maintain control of it until the child is about to enter college. At that point, they could transfer ownership to a parent. Then, when withdrawals are subsequently made for college expenses, those monies would not count as income to the student in the financial aid calculation.

**Tactic 9**

**Make a Grandparent’s 529 Account a “Just in Case” Retirement Account**

Many grandparents want to help their children and grandchildren by saving for some of their grandchildren’s college expenses, but worry they may need that money themselves if, say, they live longer than expected or incur high medical, home healthcare, or nursing home expenses. The good news is that grandparents can take a non-qualified withdrawal from a 529 account they own in the event that need arises. They would owe a 10% tax penalty, plus regular income taxes, on the earnings component.
of that withdrawal, but, given the new lower tax rates under the Tax Cuts and Jobs Act, this may still be a viable option. And if no emergency arises, the account would still be available for the grandchild’s education.

Let’s assume a grandparent is in the 12% federal income tax bracket and living in a state with no income tax, such as Florida. In this case, the maximum tax and penalty on investment gains would only be 22%. (Contributions can be withdrawn without tax or penalty.)

*Here’s a hypothetical example. Alan, a Floridian, deposits $15,000 each year for four years into a 529 plan for his grandson, and those funds earn 7% annually. Before the grandson goes to college, Alan needs that money and withdraws it for his own use—unrelated to education expenses. The net rate of return on his money, after the 12% federal tax and 10% penalty, is now 5.7% rather than 7%—still a solid after-tax return.*

Here’s another way to minimize taxes. If a grandparent needed to make a non-qualified 529 plan withdrawal while also drawing retirement income from both Roth and regular IRA assets, the grandparent could choose to withdraw more Roth assets in the year the 529 plan withdrawal is made. (Remember, all withdrawals from a regular IRA are taxed as ordinary income.) This would keep the tax rate they pay down that year, or maybe eliminate it altogether, leaving them to pay just the 10% penalty. If they wish, grandparents could prepare for this approach by converting traditional IRA assets to Roth IRA assets in earlier years.

### Tactic 10

**Earmark an Expected Inheritance to Pay Off Student Loans**

Some grandparents will be reluctant to put any significant amount of money into a 529 plan today because they are worried they may need access to those funds down the road. Others simply may not be able to make gifts to a 529 plan because a significant part of their wealth is tied up in non-liquid assets, such as a home or other real estate.

If there is nonetheless a high likelihood that the grandparent will leave an inheritance to the grandchild, this can be factored into college funding plans. It begins with the grandchild borrowing in her own name to pay for college. Then, upon graduation, she immediately consolidates her loans and enrolls in an Income Driven Repayment (IDR) plan, which sets monthly loan repayments based on income and family size. The IDR plan may be able to keep monthly payments low while the grandparent is alive. Then, when the graduate inherits her grandparent’s bequest, she can retire the loan. This strategy requires the grandparent to ensure her will is structured to leave an appropriate amount of assets to the grandchild. Even then, families need to be cautious, and consider the implications if the inheritance, for whatever reason, does not materialize, since IDR loans can last for 20 to 25 years.
Tactic 11
Convert to a Roth IRA and Leave It for the Grandchildren

Grandparents who want to leave assets to a grandchild eventually, but do not want to lose control of those assets by gifting them today, have still another option available to them if they have a traditional IRA assets. This strategy calls for them to convert their a traditional IRA to a Roth IRA over time, naming the grandchild as the beneficiary. By doing the conversion over time, the grandparent may be able to pay a low amount of taxes on each conversion. Since the Roth IRA is not subject to the Required Minimum Distribution rules (RMD) the asset doesn’t need to be depleted by the grandparents prior to death. In the meantime, those Roth IRA assets can be invested for growth and left to the grandchild on a tax-free basis at the grandparent’s death. Then, the Roth assets can be withdrawn on a tax-free basis and used to pay for college, or to retire the grandchild’s student debt.

Tactic 12
Use Life Insurance to Create Certainty

While saving in a 529 plan for a grandchild’s college education can be an effective strategy, it comes with some risks. What if the grandparent dies before fully funding the intended gifts to the 529 plan? What happens if investment results are poor, leaving insufficient funds to pay for college? One way to create certainty is to purchase a life insurance policy with a death benefit earmarked for the grandchild, as the death benefit will be paid out at some point as long as premiums are paid on time. With this strategy, the death benefit is paid on a tax-free basis to the named beneficiary (parent or child), and those proceeds can then be used to pay for the grandchild’s college education or to retire outstanding student loan debt. Although the death benefit might not be paid until after the child has completed college, loans might be used in the interim to pay for college expenses.

Permanent life insurance policies work best for this strategy and help build on flexibility for the use of funds. With a careful premium payment strategy, the policy becomes a source of college funding while the grandparent is alive through loans and withdrawals of basis, neither of which would result in higher income taxes. If the policy values are not needed for college, they provide an additional source of income tax-free retirement assets.
Tactic 13
Maximize Time Value of Investing by Not Waiting Until the Birth of a Grandchild

29 plans are powerful investing instruments by virtue of their tax benefits, which allow beneficiaries to pay no taxes on investment earnings if they are used for qualified educational expenses. Most 529 plans also allow for large investments into equities, which, relative to bonds, may generate greater potential wealth. Consider what would happen, though, if a grandparent could extend the time horizon over which those 529 deposits could grow? Grandparents can do just that using the approach described under Tactic 7 for parents. In this case, the grandparent opens a 529 account prior to a child being conceived, then, once the child is born, changes the beneficiary to either the child or the child’s parent.

To illustrate, assume Frank is 58 years old with one child, Linda, who is now out of college. Linda wants to eventually have children. Frank’s parents helped him defray the cost of Linda’s college education, and Frank wants to do the same for Linda. He could set up a 529 plan today and name either himself or Linda as the beneficiary. Once Linda’s first child is born, the beneficiary can be changed to the child without tax consequences.

Assuming a 7% annual rate of return, a deposit of $100,000 made into a 529 account five years prior to the ultimate beneficiary being born would grow to $474,000 by the time the child entered college. If the parents end up producing multiple grandchildren, the beneficiary could again be changed so that all of those grandchildren could benefit from the gift.

Tactic 14
Pay the College Directly for the Grandchild’s Tuition

While delay may not be the best course of action, all is not lost if a savings strategy was not implemented and now that grandson or granddaughter is ready to head off to college. Under a provision of the Internal Revenue Code, anyone can send a payment for tuition directly to the educational institution and not have it count towards, or be limited to, the $15,000 annual gift tax exclusion. This only works for the tuition portion of the bill, not books, supplies, or living expenses. Grandparents should be aware that this action could impact the student’s eligibility for need-based financial aid.
Getting Going

College costs show no signs of slowing down anytime soon. For families all across America, figuring out workable funding strategies will remain a challenge.

As noted earlier, the best thing parents can do is to start saving early, automate regular contributions to a tax-preferred savings account via payroll deduction or bank transfer, and adopt an appropriate investment strategy. But by taking advantage of some of the funding tactics outlined in this report, where it fits with their circumstances—parents may be able to improve the odds of having the money they need to help their children get the education they want and deserve.

Also in This Series:

- Paying for College – A Practical Guide for Families
- Student Loan Repayment – Options to Pay Off Debt
- Student Loan Debt: Implications on Emotional and Financial Wellness

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