BEDEL FINANCIAL CONSULTING, INC.

Financial Planning and Investment Management

EDUCATION FUNDING

WHAT YOU NEED TO KNOW TO SAVE FOR COLLEGE AND SAVE ON COLLEGE

By Elaine E. Bedel, CFP®

President, Bedel Financial Consulting, Inc.

INTRODUCTION

The cost of college is increasing each year. Last year, tuition and fees rose 4.8 percent at U.S. public universities and 4.2 percent at private colleges. Despite the fact that 2012 saw the smallest increase in 12 years, The College Board®, a non-profit association of 4,500 schools, reported tuition costs are still rising faster than the rate of inflation and the average increase in personal incomes.

The four-year projected cost of tuition and fees for students enrolling in private colleges in 2012 was $127,100. For students enrolling in 2030, the four-year projected cost of tuition and fees is expected to be $362,800 (based on a 6-percent annual increase). For in-state residents attending public universities the respective costs and projected costs are $37,800 and $108,100. And that doesn't even include room and board, books, and other expenses.

It's never too early to begin planning to fund your child's education. Here are some options for saving as well as some additional financial strategies and information that will help you get a head start on meeting those education costs.

EDUCATION SAVINGS ACCOUNTS AND PREPAID TUITION PLANS

With the increased cost of education, more parents and grandparents are seeking multiple methods to efficiently and effectively accumulate funds for education. A dedicated savings plan is one of the best vehicles to ensure education funds will be available when your child or grandchild is ready to attend an school or an institution of higher learning.

The federal government has provided opportunities to encourage the saving for education. Two of the most popular programs are the Coverdell Education Savings Accounts and 529 Savings Accounts. There's also an Independent 529 Savings Plan sponsored by private colleges. Each plan has similarities as well as differences, so carefully weigh the pros and cons of each as they apply to your specific situation.

Saving for college is important. Knowing your options can increase your ability to meet your child's needs as well as your long-term strategy.

Here's a look at what each of these three plans have to offer.

COVERDELL EDUCATION SAVINGS ACCOUNTS

The Taxpayer Relief Act of 1997 created the Education IRA. The program was revised by the Economic Growth & Tax Relief Reconciliation Act of 2001 and renamed the Coverdell Education Savings Account.

Purpose: This savings program is for paying K-12 and higher education expenses.

What it covers: Qualified expenses include tuition, fees, books, tutoring, room and board, supplies and equipment. It also covers computer equipment or technology and Internet access used at home by the student and family as long as the account beneficiary is in school.

How it works: Taxpayers can make a nondeductible contribution to a Coverdell account of $2,000 (maximum) per year per beneficiary who is under age18. The income earned each year is deferred and remains untaxed if used for education expenses.

A contributor can establish multiple Coverdell accounts, each with a single named beneficiary. If a parent and a grandparent each establish an account for the same beneficiary, the total contribution by both parties cannot exceed $2,000 in any year.

The $2,000 annual contribution limit is phased out for joint tax filers with modified adjusted gross income above $220,000 ($110,000 for single filers). This may restrict many potential contributors from using this vehicle.

The $2,000 contribution is also subject to the gift tax rules, and should be coordinated with the annual gift tax exclusion.

Distributions: Distributions are excludable from gross income to the extent that the distribution does not exceed qualified education expenses (net of any tax-free scholarships received). Any balance remaining in the account at the time the beneficiary becomes age 30 must be distributed to the beneficiary. However, it's also possible to roll over any remaining amounts to the account of another qualifying beneficiary such as a sibling who is under the age of 30.

For non-qualified withdrawals, the earnings portion of such a distribution will be included in the gross income of the beneficiary and subject to an additional 10-percent penalty tax since the distribution was not used for educational purposes.

However, it's also possible to roll over any remaining amounts to the account of another qualifying beneficiary such as a sibling who is under the age of 30.

Ownership/custodianship: It is important to note that the beneficiary has control of the account and is considered the owner, even though a parent or guardian is serving as the custodian. The custodian of the account must administer the account for the benefit of the child/beneficiary. All withdrawals are paid to the beneficiary and not to the custodian or person who established the account.

Impact on federal financial aid: Coverdell Education Savings Accounts can be considered an asset of the student and not the parents if the student is no longer a dependent. Therefore, it can be a disadvantage when applying for federal financial aid. Federal financial aid programs assume 20 percent of the value of the Coverdell account is available for the child's education costs, whereas they assume only 12 percent of assets owned by the parents are available for the child's education costs. Each college or university establishes its own rules for inclusion of child and parent assets when determining financial aid, and they may differ from the federal program.

529 SAVINGS PLANS

The 529 Savings Plans were created in the mid-90s by the federal government under Section 529 of the Internal Revenue Code. This legislation enables the individual state governments to create college savings plans with special benefits.

Purpose: This savings plan is for paying post-secondary education costs.

What it covers: Qualified expenses including tuition, room and board, mandatory fees, required books and computers for public and private colleges or universities, trade schools and vocational schools. It cannot, however, be used for elementary and secondary education costs.

The funds can be used for higher education in any state, not just your state of residence. Therefore, you can participate in the 529 Plan of any state.

How it works: As with the Coverdell savings accounts, contributions to the 529 Plan are non-deductible, the income earned each year is deferred, and it remains untaxed if it's used for qualified education expenses.

There are, however, several differences between the plans.

You can contribute as much as you'd like each year to the 529 Plan, limited only by the gift tax provisions, versus the $2,000 limit per beneficiary in the Coverdell accounts. Each 529 Plan sets its own lifetime limit for contributions to any one account, but it's generally more than $100,000. A special provision allows a contributor to "jump start" a 529 Plan by contributing up to five years of gifts in a single year. For example, if the annual gift exclusion is $14,000, you can contribute $70,000 ($14,000 times 5) to the account. As a result, you cannot make a gift to the child under the annual exclusion for a full five years.

There are no adjusted gross income restrictions limiting the person who can contribute to 529 Plans. Therefore, everyone is eligible to contribute. You can also contribute to a 529 Plan in the same year that you contribute to a Coverdell Education Savings Account.

Distributions/ownership: The owner of the 529 Plan account, generally the parent, controls distributions, withdrawals and the changing of the beneficiary. This provides several additional benefits over the Coverdell account. If the beneficiary has completed college and no longer needs the funds, the owner can change the beneficiary to another sibling, to herself or himself, or to another qualifying family member. There is no requirement that the funds be used by age 30 or that an individual be under the age of 30 years when named as the beneficiary.

Withdrawal options: The owner of the account also has the ability to reclaim and withdraw the funds. If the funds are distributed for non-educational purposes, ordinary income tax and a 10-percent penalty are imposed on the earnings only. This flexibility allows you to use the funds not needed for your child's education for your own retirement. You can also roll a 529 Plan into the Independent 529 Savings Plan at any time with no tax or penalties.

Impact on federal financial aid: At this time, the 529 Plan is considered an asset of the parents and has a lower impact on the Free Application for Federal Financial Aid. However, this may change in the future. As mentioned earlier, each individual educational institution has its own unique formula for determining aid, which may include both the 529 Plan and the Coverdell account balances.

PRIVATE COLLEGE 529 PLAN

If you attended a private college or university it's likely you'll want to fund a college savings plan to cover the costs of a private education for your children. The Private College 529 Plan, established in September 2003, is a prepaid tuition program sponsored by participating private colleges and universities rather than an individual state.

The Private 529 Plan is administrated by Tuition Plan Consortium, LLC, and managed by Oppenheimer Funds. You can find additional information including the current list of participating private colleges at privatecollege529.com. This website also provides helpful calculators.

As we noted earlier, the cost of college continues to increase at an annual rate greater than inflation. If funding a private education is your goal, you should consider the Private 529 Plan for a portion of your child's education savings. As with any savings strategy, you must consider all your investment options and formulate a plan that will provide you the greatest opportunity to meet your goals.

Purpose: This prepaid tuition plan locks in current tuition costs at participating private colleges and universities so your child's future undergraduate education is based on today's prices (plus an added discount of .5 percent to 2 percent annually).

What it covers: Qualified expenses include tuition and other mandatory costs of undergraduate education at participating schools. It doesn't pay for any additional education costs such as room and board, so you may want to also contribute to a state-sponsored 529 Plan to cover those expenses.

How it works: Your contribution to the Private 529 Plan purchases a certificate which can be used to pay for tuition and mandatory fees at any participating school, **once you have held it for a minimum of three years.** Contributions are made on after-tax dollars, so you don't pay federal or state taxes on any earnings as long as they are used for tuition and mandatory fees. There are no investment fees or administrative expenses to pay, so all your money is invested in the plan. If you use the money for non-qualifying expenses, however, you'll have to pay the taxes plus a 10-percent penalty on the earnings received.

Currently more than 270 schools participate in the Private 529 Plan. Its impressive roster includes Notre Dame, Duke, Stanford, MIT and Princeton, but you don't need to commit to a specific school at the time of purchase. Your certificate is good at any participating school as well as any school that enters the program after you purchase your certificate. If a school that was on the list at the time you purchased the certificate drops off, it will still honor your certificate.

Here's an example of how the plan works:

- Let's assume you want to pay for tuition and fees at the University of Notre Dame (ND) for your three-year-old child. For the 2012-13 school year, ND tuition and fees totaled $45,000.

- The discount rate for ND is 0.5 percent. Between now and your child's freshman year in 2028, the cost you pay would be reduced from today's cost by one-half percent for each of the fifteen years. That will reduce the cost to approximately $41,750. However, in 15 years, assuming a 6-percent annual increase, the expected cost of tuition and fees at ND is $110,000. Therefore, if you purchase a certificate in the Private 529 Plan today for $41,750, you can use the certificate for your child's freshman year tuition at ND even though it is anticipated to cost $110,000.

- (FYI: It would cost about $194,000 today to purchase certificates to fund four years of tuition at ND starting in 2028. The expected cost of tuition assuming 6-percent annual increase is nearly $484,000 for that same period.)

- Of course, if you invested $41,750 in a state-sponsored 529 plan today, you could reasonably expect to earn more than 6 percent per year. However, your investment return is not guaranteed. With the Private 529 Plan, the participating school takes the investment risk by guaranteeing your child's tuition and fees. In the Private 529 Plan, your investment return is guaranteed to be the school's annual increase in tuition costs plus the discount rate for the school. In our example, the guaranteed rate of return would be 6.5 percent.

Ownership: Purchasing a certificate is no guarantee your child will be admitted to a private school—or that he or she will even want to attend one. If that's the case, you have options. At any time, you can change the beneficiary under the same provisions that apply to the state-sponsored plans. You can even name yourself as beneficiary. And the certificate is good for 30 years.

Withdrawal options: If no one is going to use the certificate, you can withdraw the funds. You'll receive your contributions plus the net performance of the Program Trust, capped at plus or minus 2 percent per year. If you use the refund from the Private 529 Plan for qualifying education expenses, you won't have to pay any taxes or penalties.

You can also roll your refund amount into another 529 Plan at any time, without having to pay any taxes or penalties.

ALTERNATIVE FUNDING SOURCES

Education savings accounts and prepaid tuition plans aren't the only available options when it comes to funding higher education. Funds to pay college tuition and expenses can come from many sources.

If you had planned to use your investment portfolio to fund your child's college educations, before you cash-in, consider gifting appreciated securities to your child. As an added bonus, you'll reap a tax benefit.

APPRECIATED SECURITIES

Long-term capital gains tax can range from 0 percent to 20 percent depending on income and filing status. This can provide an opportunity to reduce the family tax burden while providing funds for your child's college education.

Once you understand the various taxing and gifting implications, you can make a plan that will allow you to utilize the reduced tax rates to your advantage.

Here are some things to consider.

- **Tax rate reduction.** For assets held longer than 12 months, the capital gain tax rate for most is 15 percent or 20 percent depending on your income and filing status. However, for filers with lower taxable income, the long-term capital gain rate is 0 percent.

- **Kiddie tax.** For any child under the age of 18 years with unearned taxable income greater than $2,000, the excess income is taxed at his or her parents' tax rate. The income tax will be taxed at the child's tax rate only if he or she has enough earned income to provide more than half of their support.

- **Annual gifting.** You can gift up to the annual gift tax exclusion each calendar year to as many individuals as you would like, exempt of gift tax. If married, you can double the amount. When you gift an appreciated asset such as a stock or mutual fund the new owner maintains your cost basis and your holding period. If the new owner sells the stock or mutual fund, he or she will owe capital gain tax on the difference between the value at the time of sale and your original purchase price. If the combined holding period between you and the new owner is greater than 12 months, the capital gain will be considered long-term for tax purposes.

To provide funds for college, it may be more tax-efficient to gift an asset to your child so your child can sell it to raise the cash to pay for college.

Here's an example:

> Sam has a daughter, Nancy, who is graduating from high school this year. Nancy plans to attend college in the fall. After scholarships, Nancy will need around $10,000 to pay all the bills. Sam has accumulated a stock portfolio over the years just for this purpose. After reviewing his portfolio, Sam decides to liquidate 200 shares of ABC stock valued at $50 per share for a total of $10,000. Sam paid $10 per share for the stock more than 10 years ago. Therefore, his long-term capital gain per share is $40 for a total taxable gain of $8,000. The tax that Sam will owe on this sale is $1,200 ($8,000 X 15 percent = $1,200). After paying the tax, Sam will have $8,800 to help meet Nancy's college expenses.

> Instead of selling the stock and paying the education bill, Sam is advised to gift the 200 shares of stock to Nancy. Since the total fair market value of the gift is $10,000, Sam will incur no gift tax liability. Nancy can sell the stock, pay the tax and use the remaining funds to pay for school. Since Nancy is 18-years-old, the “kiddie tax” does not apply. Nancy has a part-time job, but expects to earn less than $7,000 for the year, so she will qualify for the lower capital gain tax rate. When Nancy sells the stock, she will have the same long-term capital gain as her father, which is $8,000. However, Nancy will be in the 0-percent capital gain bracket. Using this strategy, Nancy will have the full $10,000 after she pays the tax. This is $1,200 more than her father would have netted from the sale.

Before you write a check for your child’s tuition, review your own investment portfolio. If you have appreciated stock, consider using the above strategy. By shifting the capital gain tax to your student, more funds are available to pay those college expenses.

FREE APPLICATION FOR FEDERAL STUDENT AID

With the increasing cost of college, you need to take advantage of all available financial aid. If your child is entering college this fall (or is a returning college student) you’ll want to complete the Free Application for Federal Student Aid (FAFSA) and submit it by the March 10th deadline (for Indiana residents). Colleges and universities use the information from the FAFSA to put together a student aid package to offer to a student. Student aid packages can include federal loans, state loans, need-based scholarships and work-study opportunities.

The financial aid package you will be offered is based on three variables:

1. The cost of attending the college.

2. Any outside resources such as scholarships that your student has earned.

3. The "Expected Family Contribution" (EFC). The EFC is the amount the family is expected to pay for college based on their financial situation as indicated from the FAFSA information.

PREPARING TO COMPLETE THE FAFSA

The FAFSA must be completed for any student entering or returning to college. If your student is a dependent, your financial information as well as your child's financial information is required. If your student is considered to be financially independent, only his or her financial information is reported, and the financial aid package will be based only that information. This is most likely to be the case for post-graduate students.

If you've submitted a FAFSA and have been denied financial aid in the past, you'll still want to complete it each year, especially if you now have another student entering college. The FAFSA takes into account the total number of college-bound students in your family, so your financial aid may be increased. But any change in the family financial situation or the educational institution can impact the outcome.

Here's the basic information you'll need to report:

- **Tax information from the prior year.** Before you begin working on the FAFSA, you should gather your financial information. Since you'll need to include tax information from the prior year, it's helpful to complete your income tax return first. If this isn't possible, you'll be required to provide an estimate and later revise the tax information if necessary.

- **The value of certain assets.** This includes the value of your cash, checking, savings and investment accounts and real estate as well as information regarding your child's income and the value of his or her checking, savings or investment accounts. There are several exclusions, however: retirement accounts and pension funds, cash value of life insurance, annuities, and the home that you live in. Also excluded is the value of any family business or family farm as long as certain requirements regarding size are met.

CALCULATING "EXPECTED FAMILY CONTRIBUTION"

The amount parents and students are expected to contribute to the cost of college is also determined from the FAFSA information. The greater the amount the institution feels you and your student can afford to pay, the less financial aid your student will receive.

Here are the formulas used to calculate the EFC for students and parents.

Student contribution. The first part of the EFC calculation is the student contribution. It consists of an assessment on both income and assets.

- **Income earned:** The formula assumes that 50 percent of your student's income above the income offset is available for spending on college. For example, if a student earns $10,130, the formula would calculate $2,000 as available for school.

- ($10,130 - $6,130 = $4,000 X 50 percent = $2,000).

- Looked at from the perspective of financial aid eligibility, this means the amount of financial aid offered will be reduced by $2,000.

- **Assets owned:** If your student owns an asset, the formula assumes that 20 percent of the value of that asset is available for college expenses. For example, if the student's savings and investment account have a value of $12,000, the financial aid eligibility is reduced by $2,400.

    - **Planning tip:** There is an exception for 529 College Savings Plans. Instead of including 20 percent of the 529 Plan value, only 5.6 percent is included. Therefore, if your student has savings and investment accounts, you may want to move these funds into a student-owned 529 Plan. This should increase the amount of financial aid for which he or she can qualify.

Parental contribution. The second part of the EFC calculation is the parental calculation. It also includes both an asset and income assessment. Depending on the overall amount, the formula assumes that 22 percent to 47 percent of calculated income by parents is available for college.

- **Assets owned:** The formula assumes that only 12 percent of includable assets owned by parents, less an asset protection allowance, is available for college expenses. Excluded assets include: IRAs and retirement plans, home equity and a family-owned business with less than 100 employees.

- **Income earned:** The parental income calculation is a little more complex. Simply put, after subtracting assets and the variable income protection allowance, the remaining income is added to the calculated available assets to determine an adjusted income. The value in excess of a predetermined assessment is multiplied by 22 percent to 47 percent and added to the predetermined assessment amount. Very simple, right?

For more information or to complete the FAFSA online, go to: www.fafsa.gov.

THE PROCESS: FROM FAFSA TO FUNDING

Here are the seven steps in the process for obtaining federal funds for your child's undergraduate or graduate education.

1. Your student completes the FAFSA online. This is key to the process and should be done as early as possible after January 1.

2. On the FAFSA, your student will indicate the schools that are being considered or, after the first year, the educational institution that he or she is attending.

3. The FAFSA is processed and approved by the government and then forwarded to the school(s) listed.

4. The financial aid department of each school uses the information on the FAFSA along with their funding formula to determine the amount and type of aid for which your student qualifies. This may include government loans as well as the school's own loan and grant programs.

5. The school provides your student with a financial aid package that includes sufficient funds for tuition, books, fees and living expenses. The school also provides a list of financial institutions through which the loans can be secured.

6. Your student works directly with a loan provider to complete the loan process.

7. The financial institution disburses the funds directly to the school. The school transfers the funds to be used for living expenses to your student.

FINANCING GRADUATE SCHOOL

Graduate school is an expensive endeavor. Often both students, who are now typically considered to be independent, and parents are involved in determining the appropriate financing for this level of education.

Given the low borrowing rates and the interest-free or interest-deferred provisions of Stafford loans, using this funding vehicle as part of the package may be a good use of the overall family resources. A graduate school funding package may include Stafford loans, Graduate PLUS loans and grants and loans offered by the educational institution.

STAFFORD LOANS

Stafford loans are facilitated by the federal government to assure all students who qualify to attend an educational institution have the financial resources to do so. There are two types of Stafford loans, subsidized and unsubsidized. As of July 1, 2012 only unsubsidized Stafford loans are available to graduate students.

With an unsubsidized Stafford loan, the interest can:

- accrue during the time your student is in school and be added to the loan balance (deferred).
-
- be paid by your student from the time the loan is initiated.

No payment is due on the principal as long as your student attends graduate school on at least a part-time basis. Six months after your student graduates or is no longer enrolled in graduate school, he or she must begin to make a regular loan payment, including interest and principal.

GRADUATE PLUS LOANS

Another type of low-interest loan that is guaranteed by the federal government is the Graduate PLUS loan, or Grad PLUS. It is fixed at 7.9 percent, and payments can be deferred while the student is attending graduate school. No cosigner is required for this loan, and interest payments may be tax deductible.

Students can borrow an amount up to the cost of attending school, minus the total of any other financial aid they may receive.

A Grad PLUS loan is not based on financial need, family or student income or value of owned assets. It does require potential borrowers to pass a credit check, and those with adverse credit can be denied.

APPLYING FOR LOANS

Parents apply for federal loans when the student is an undergraduate. For graduate school loans, your student usually applies as an independent. Under this scenario, only the financial resources of the student are included in the calculations that determine the amount of outside funding necessary to provide for all education expenses.

Likewise, this formula does not assume a financial contribution on the part of the parents. The government does not require information from the parents for Stafford loans or Graduate PLUS loans. However, the graduate school's financial aid office may require parent information for any grants or loans provided directly by the educational institution.

As with undergraduate school, completing the FAFSA is the first step in the process.

AFTER SCHOOL, CONSIDER LOAN CONSOLIDATION

Once your student has graduated or left school, he or she will probably have several loans. Loan consolidation is a convenient option that simplifies payments, but it isn't necessarily the best option. It can only be done once, so your student will want to do his or her homework to determine if loan consolidation is beneficial.

With loan consolidation, the interest rate on the single consolidated loan is based on the actual individual loan rates as well as the current interest rate. Depending on future changes in the borrowing rate, consolidation may or may not be advisable.
Another thing to consider: a Stafford loan may be forgiven in the event of death of the borrower. Review the consolidation loan document carefully to determine whether this provision is included.

IN SUMMARY

The cost of education today is high and ever-increasing, but it's one of the best gifts you can provide your child. The sooner you begin saving, the better. There are several vehicles available to you such as savings plans, prepaid tuition plans and gifting. Being knowledgeable about all your options can increase the funds your child will have when the time comes.

ABOUT BEDEL FINANCIAL CONSULTING, INC.

Elaine E. Bedel, CFP®, is president of Indianapolis-based Bedel Financial Consulting, Inc., a wealth management firm. Bedel Financial Consulting provides fee-only financial planning and investment management services for individuals, consulting services for corporate retirement plans and investment advisory for institutions and endowments.

Bedel Financial Consulting works with clients to efficiently and effectively use their financial resources to accomplish their short-term and long-term goals. The firm provides guidance in the following areas:
retirement planning
investment strategies and management
stock option analysis
education funding
income tax planning
insurance needs analysis
estate planning
charitable planning
divorce settlement issues
family needs planning

For more information, visit **BedelFinancial.com** or email your comments to Elaine E. Bedel at **ebedel@bedelfinancial.com**