

**NATIONAL INSTITUTE OF
CERTIFIED COLLEGE
PLANNERS, LLC**

Certification Program

Module 2

Saving for College

Module 2 Introduction

- Retirement savings is the priority because:
 - Student has college resources
 - Parents have only a few years to save
- Family goals & objectives determine the best investment accounts
- Investment choices have different rules, tax implications, and financial aid effect

Module 2 Introduction

A good rule of thumb when investing for college is to give greater priority to your retirement savings than to college savings. There are two reasons for this:

- ✍ First, the student has resources to draw on besides you to help pay for college, but your client can't get a scholarship to retire, and
- ✍ Second, many parents have only a few years to save for retirement, once the last child graduates. Considering the number of children they may have to educate and the high price of college, they may be better off to borrow for college than neglect their retirement goals.

Everybody assumes that 529 Plans are the best way to save for college. In reality, this may not be the case. It just depends on the family's financial goals and objectives. Every family has different circumstances from which they must make the final determination on which investment account is best.

Module 2 will help the financial advisor understand the various choices when it comes to investing for college, including 529 savings plans, Coverdell Education Savings Accounts (formerly Education IRAs), custodial accounts (UGMAs/UTMAs), and tax-efficient mutual funds. Each has different rules and tax implications, and each is counted differently when it comes to financial aid eligibility.

Define Financial Goal

- Determine a specific amount needed at a certain date
- Remember college inflation (rate 2-3 times)
- Create an investment plan to meet the goal
- Consider the amount of time available to save

To begin the savings or investment process for college, an investor must define his financial goal or the specific amount of money that is needed to be available at a certain date for education costs. Once a goal is established, an investment plan that will meet the goal must be created. One of the primary factors in creating an investment plan is the amount of time available to save.

Start Saving ASAP

- Provides greater investment options as to the types of investments
- Allows investments to grow
- Reduces necessary annual contribution

Ideally, an investor starts saving as soon as possible -- for parents, at their child's birth. The earlier an investment plan is implemented, the greater the options. In addition to allowing investments to grow, an early start will reduce the necessary annual contribution to the investment.

Once it's been determined how much money to set aside, the decision is how to invest it. Depending upon the given situation and the number of years until the college education needs to be funded, choices include many types of investments.

Section 3: Will The Program Approve A Request To Transfer Ownership Of The Account?

- Some programs will not allow transfer of ownership unless:
 1. Death
 2. Incapacity
 3. divorce court order
 4. other legal proceeding
- Need to first rollover account to another program that permits owner transfers

Section 3: Will The Program Approve A Request To Transfer Ownership Of The Account?

There are a number of reasons why you may decide you want to transfer ownership of your 529 account to someone else. One possibility is that an account owned by you may be subject to the claims of your creditors. Another possibility is that you do not want your account considered a countable asset for Medicaid purposes if you were to enter a nursing home in the future. Finally, you may at some point decide that just do not want to be responsible for the management of the 529 account and would like someone else to handle it. The last two possibilities are particularly relevant for grandparents.

Some 529 plans do not approve requests for a transfer of ownership other than following your death or incapacity, or when ordered by a court in a divorce or other legal proceeding. To accomplish such a change, you would need to first rollover your account to another 529 plan that does permit owner transfers.

Zero Coupon Bonds

- A specific amount can be invested with a specific maturity amount
- Bought at a discount from its face value
- A current rate of interest can be locked in for the long term
- No distribution until maturity
- The accrued interest is currently taxable
- If the issuer defaults, the bond will have a zero return

Zero Coupon Bonds

Zero coupon bonds may be the backbone of many families' college funds. The reason for this is that the investment return is so easy to understand. The unique value of all zero coupon bonds (treasury zero bonds, municipal zero bonds, and zero corporate bonds) is that a specific amount can be invested today and the investor knows exactly what the investment will be worth at maturity. A current rate of interest can be locked in for the long term.

What Are Zero Coupon Bonds ?

The owner of a traditional coupon bond receives regular interest payments and then must reinvest that interest at whatever rate the market offers at the time. Zeros, however, pay no regular interest. In fact, they pay nothing at all until they actually mature. Rather, a zero coupon security is bought at a discount from its face value. In general, the longer the time until maturity, the more substantial the discount. The return is the difference between what is paid for the zero bond at the time of purchase and what it sells for or what it pays when held to maturity. Obviously, if interest rates go *down* while holding a zero bond, it's owner will do very well because they are locked into a higher rate. If

rates go up during that period, however, the owner will do worse than someone who could reinvest interest at the higher rates. However, the rate of return earned will be assured when the bond is held until maturity.

The following are the four types of zero coupon bonds:

1. Zero Coupon Treasury Bonds - These are actually U.S. Treasury bonds or notes that have been stripped of their coupons by the Treasury. A broker, bank, or other institution then markets the stripped bonds at a discount and the purchaser receives the face amount at maturity .
2. Zero Coupon Certificates of Deposit – These CDs are issued by banks and are insured up to the FDIC rate (\$100,000). They are offered at a larger discount than the ZC Treasury Bonds, thereby giving the investor a higher return on investment.
3. Zero Coupon Corporate Bonds - These bonds are issued by corporations and provide a greater rate of return than either ZC Treasury Bonds or ZC CDs because they are not Insured against the corporation defaulting at maturity and the investor assumes more risk.
4. Zero Coupon Municipal Bonds - These bonds are similar to municipal bonds in that they provide interest income that is not subject to federal and state taxes.

The Pros & Cons Of Using Zero Coupon Bonds For College

The following are benefits common to most Zero Coupon Bonds:

1. If the bonds are held to maturity, the investor is assured of a specific yield.

2. A relatively small investment is required to purchase Zero Coupon Bonds.
3. Yields are usually higher than most other Treasuries.
4. Maturities can be staggered so the bonds mature as the proceeds are needed.

The disadvantages of Zero Coupon Bonds are:

1. The investor receives no interest until the bond matures, but the accrued interest is taxable.
2. Unless it is held until maturity, the longer the term of the bond, the greater the possible volatility of the bond price.
3. If the issuer defaults, the bond will have a zero return as interest is paid only at maturity.


If the maturity of zero bonds are timed to when the cash is needed, zero bonds are a very handy way to match a child's projected college expenses with an investment that will have a specific, predictable value at that time. The difference between what the initial cost for the zero bond and what it can be cashed in for at maturity, is a true compounded rate of interest; as if that interest had actually been paid to you several times a year and reinvested it at the same rate each time. Compound interest is a powerful engine for growth.

pay for qualified education expenses. Tax-free distributions from a CESA, qualified U.S. EE Savings bond, or employer-provided educational assistance will reduce the amount of qualified education expenses for the penalty free IRA distribution.

Example: Larry is a dependent on his parents' return during his high school years. During these years, a traditional IRA is used to reduce Larry's taxable income to zero each year. Upon entering college, Larry claims himself as a dependent because he provides over one-half of his own support by paying tuition and room and board from his own funds. Assume that Larry's \$7,000 of IRA contributions have appreciated to \$9,000 (including \$2,000 of earnings) by the time he enters college.

The following summarizes the tax treatment over his last four high school years and his first college year:

	Dependent				College: Not Dependent
Age	<u>15</u>	<u>16</u>	<u>17</u>	<u>18</u>	<u>19</u>
Wages	\$1,500	\$3,000	\$4,000	\$4,000	\$4,500
Int/Div/CG	1,500	2,000	2,250	2,250	3,000
IRA	(1,250)	(1,750)	(2,000)	(2,000)	9,000
Personal Exmpt.					(2,800)
Std. Deduction	<u>(1,750)</u>	<u>(3,250)</u>	<u>(4,250)</u>	<u>(4,250)</u>	<u>(4,400)</u>
Taxable Income	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$9,300</u>
Tax					\$1,095
Hope Credit					<u>(1,095)</u>
Total					<u>\$ 0</u>

Effectively Larry has managed to avoid tax on his investment income during his high school years through the use of a deductible IRA, and then later is able to avoid all tax (and penalty) on the IRA withdrawal through the use of the education credits. 

Gifts Through Custodial Accounts

- Simplest long-term funding-method
- Income is taxed to the child regardless of whether it is distributed
 - “Kiddie Tax” rules apply if child is under 14
 - If a legal parental obligation is satisfied from the income, the donor must recognize the income
- Assets must be distributed at age of majority (age 18 to 21, as determined by state law)
- Donor loses control (unless he is the custodian)

Gifting Through Custodial Accounts

Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA) are the simplest long-term method of funding future college costs. Any income generated by the assets in these custodial accounts is taxed to the beneficiary (child), regardless of whether it is distributed. However, the “kiddie tax” rules apply to income earned on UGMA/UTMA assets if the child is under age 14. For children age 14 or older, the kiddie tax rules do not apply, and income-shifting benefits are still possible. In addition, if a legal obligation (in most states a college education is not considered a legal obligation of parental support) to support a minor child is satisfied from the income from the UGMA/UTMA account, the donor must recognize the income (regardless of the custodian) under the grantor trust rules. However, if tax-exempt income were generated from the custodial account assets, the parent would not have taxable income even when used for child support items.

A custodian takes title and holds property for the child’s benefit and must distribute the assets to the minor upon his reaching the age of majority (age 18 to 21, as determined by state law).

An UGMA is not allowed to hold real estate and various other investments. However, the UTMA is allowed to hold real estate, personal property, limited partnership units, and other investments. UGMA accounts usually terminate when the child reaches 18 years of age. Whereas, the UTMA account generally terminates at age 21. In some states the UTMA account can be extended until age 25. The UTMA's longer life may be an advantage over the UGMA.

To avoid the kiddie tax rules for children under age 14, the UGMA/UTMA account could invest in tax-free or tax-deferred investments (e.g., EE bonds, municipal bonds, annuities, life insurance, growth stocks, stock in a closely held business, land, or other growth assets) until the children reach age 14.

Planning tip: The annual \$11,000 gift tax exclusion is available for transfers to UGMA/UTMA accounts. However, UGMA/UTMA transfers will be included in the donor's gross estate if he dies while serving as the account custodian. This situation can be avoided if the donor does not name himself custodian of the account.

Example: One grandparent could make a gift of money to the other grandparent. The grandparent then gives the money to an UGMA/UTMA for the grandchild. The other Grandparent can, therefore, act as custodian without adverse potential future estate tax consequences.

The main advantage of an UGMA/UTMA account is its simplicity, low cost, and ease of administration. The disadvantages are (1) loss of control by the donor, (2) inflexible distribution requirements at the age of majority, (3) questions about education and other account expenditures as "parental support" items, (4) the kiddie tax rules that can reduce the income tax savings, (5) the prospect of the child receiving more money than he needs for college costs, and (6) the negative effect they will have on the child's financial aid (should the child qualify for financial aid).

Minor's Trusts To Shift Income

- Gifts qualify for annual gift exclusion even though the child's right to use the gift is postponed until age 21
- Principal and income must be available for the child's benefit during its term
- At age 21, the child must have the right to a full distribution of all income and principal

(cont.)

Minor's trusts [(IRC Sec. 2503(c)], also known as 2503(c) trusts, can be used for income shifting to a child. The federal gift tax law permits certain gifts to a minor in trust to qualify for the annual \$11,000 gift exclusion even though the beneficiary's right to use the gift is postponed until age twenty-one. For the gift to qualify for the annual exclusion, the principal and income of the trust must be available for the child's benefit during its term, at the trustee's sole discretion, for the purposes specified in the trust document. In addition, the beneficiary must have the right to a full distribution of all income and principal at age twenty-one (This right may be a continuing right or a right for a limited period, such 30 days after the 21st birthday.) If the child does not choose full distribution after his 21st birthday, the trust may be continued for an additional period specified in the trust. This feature can be attractive if the state of residency, under its UGMA/UTMA laws, gives the beneficiary a right to demand distribution at age eighteen.

If more than one child is to benefit from the trust, a separate share must be set aside for each child. A \$11,000 annual gift exclusion will then be available for each child benefited by the trust.