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College Planning

If you're like many families, there are a lot of demands on your hard-earned dollars. And yet it's important to start saving for college as soon as you can.

College Planning

A college education can be one of the most important investments you ever make. But the benefits of your child's increased earning power and expanded horizons come at a price — college is expensive.

Many families finance a college education with a combination of resources, but your savings are the cornerstone of any successful college funding plan. So it's important to start saving as soon as you can.

The cost of college

For 2019-2020, average costs for tuition, fees, room, and board are:

- $21,950 — public college
- $49,870 — private college (many private colleges cost substantially more)

Source: College Board, Trends in College Pricing 2019

These figure include direct billed costs only. They don't include costs for books, personal expenses, or transportation, which will vary by student.

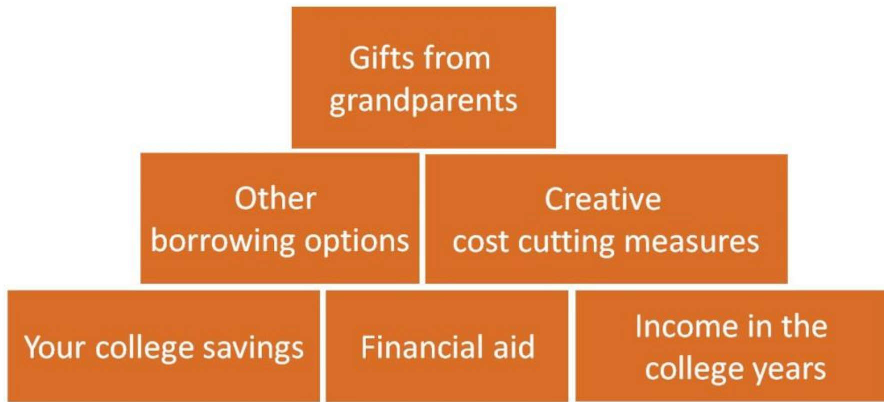
And college costs go up every year. Over the past decade, college inflation has generally increased at double the rate of general inflation. As a benchmark, annual cost increases in the range of 3% to 6% are possible.

This table can give you an idea of what your future college costs might be; figures are based on a 5% college inflation rate.

Academic year	4-year public college	4-year private college
2019-2020	$21,950	$49,870
2020-2021	$23,048	$52,364
2021-2022	$24,200	$54,982
2022-2023	$25,410	$57,731
2023-2024	$26,680	$60,617
2024-2025	$28,014	$63,648
2025-2026	$29,415	$66,831
2026-2027	$30,886	$70,172
2027-2028	$32,430	$73,681
2028-2029	$34,052	$77,365
2029-2030	$35,754	$81,233

How Are You Going to Pay for College?

Many families finance a college education with a combination of resources. Your savings will be the cornerstone of your college funding strategy, but other resources can help, too, at college time.



Many families finance a college education with a combination of resources, including savings, financial aid, and income in the college years.

Focus on Your Savings

Your savings are the most important part of any successful college funding strategy. Start saving now with whatever amount you can afford, and add to it over the years with raises, bonuses, tax refunds, and unexpected windfalls.

This table shows how your college fund can potentially grow over a period of years if you invest a certain amount of money each month.

Monthly investment	5 years	10 years	15 years
$100	$6,977	$16,388	$29,082
$300	$20,931	$49,164	$87,246
$500	$34,885	$81,940	$145,409

Note: *Figures are based on a 6% average annual after-tax return. This hypothetical example is used for illustrative purposes only and does not represent the performance of any specific investment. Fees and expenses are not considered and would reduce the performance shown if they were included. Actual results will vary. This illustration assumes a fixed annual rate of return, but rates of return will vary over time, particularly for long-term investments.*

Think of your college savings as a down payment on your child's college education, like a down payment on a house. A good benchmark is to aim to save at least 50% of your child's projected college costs.

529 plans, Coverdell Education Savings Accounts, and Roth IRAs offer federal tax advantages when used to pay for college.

College Savings Options

Where should you put your college savings? There are many options to choose from:

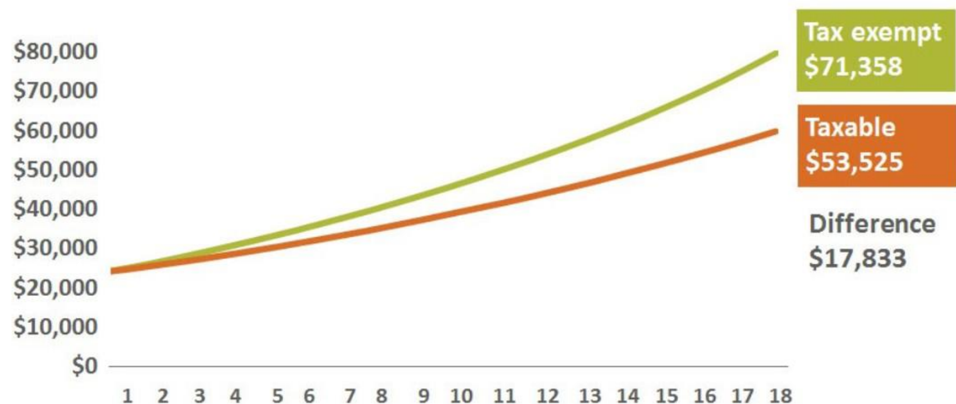
- 529 plans
- Coverdell Education Savings Accounts
- Roth IRAs
- Mutual funds, stocks
- Savings accounts, money market funds, CDs

Savings accounts, money market funds, and certificates of deposit may be a good place to park your short-term savings, but their relatively low rates of return make it hard to keep up with college inflation.

Importance of tax advantages

When saving for college, you should consider tax-advantaged strategies whenever possible. Let's look at an example. The following chart shows the impact federal income taxes can have on your college savings. Assumptions include an initial investment of $25,000, a 6% average annual return, and a 28% tax bracket.

Over 18 years, a $25,000 initial investment held in a taxable investment such as a mutual fund (at a combined federal and state tax rate of 28%), would have grown to $53,525. But that same $25,000 held in a tax-exempt investment, such as a 529 plan, would have grown to $71,358 — a difference of $17,833.



Note: *This is a hypothetical example used for illustrative purposes only and is not intended to reflect the actual performance of any specific investment, nor is it a guarantee of future value. The lower maximum tax rates on capital gains and qualified dividends, as well as the tax treatment of investment losses, would make the taxable investment more favorable than is shown on this chart. Rates of return will vary over time, particularly for long-term investments.*

529 plans

There are two types of 529 plans: college savings plans and prepaid tuition plans.

With either type of plan, you are the account owner and control the account, and your child is the beneficiary. Anyone can open a 529 account — there are no restrictions based on income. Contributions accumulate tax deferred, and earnings on contributions are tax-free at the federal level (and typically at the state level, too) if they are used to pay the beneficiary's qualified education expenses. But if contributions aren't used to pay for college, then the earnings portion of any withdrawal will be subject to income tax and a 10% federal penalty.

The following table illustrates some of the major differences between the two types of 529 plans.

College savings plan	Prepaid tuition plan
Individual investment-type account similar to a 401(k) plan; your contributions go into plan's pre-established investment portfolios that you select; returns aren't guaranteed	Contract between you and the plan whereby your contribution today covers a certain amount of in-state public college tuition in the future
Offered by nearly all states; you can join any state's plan	Only a few states offer them; you are limited to your own state's plan
Your contributions go into one or more of the plan's pre-established investment portfolios that you select	Contributions are pooled with the contributions of others and invested by the plan
Funds can be used for tuition, fees, room and board, books, and supplies at any accredited college in the U.S. or abroad	Generally covers in-state tuition only at public colleges only

Note: Before investing in a 529 plan, consider the plan's investment objectives, risks, charges, and expenses, which can be found in the plan's official statement and should be read carefully before investing. There is a risk that the investments may lose money or not perform well enough to cover college costs as anticipated. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. In addition, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. Other state benefits may include financial aid, scholarship funds, and protection from creditors.

In 2020, individuals can make a lump-sum gift to a 529 plan of up to $75,000, and couples can make a joint gift of up to $150,000. If certain conditions are met, no gift tax will be owed.

Your state 529 plan

It's always a good idea to check out your own state's 529 plan first, because your ability to take advantage of any state tax benefits may depend on whether you have joined your own state's 529 plan. Also find out what tax benefits, if any, your state offers:

- Are qualified withdrawals tax-free at the state level?
- Are plan contributions deductible at the state level? If so, is there an annual cap? If there is an annual cap, is there the ability to carry over deductions from year to year?
- Are there any state matching contributions or other saving incentives?

529 plans and accelerated gifting

529 plans offer a unique estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's education.

In 2020, individuals can make a lump-sum gift to a 529 plan of up to $75,000 and couples can make a joint gift of up to $150,000 — an amount equal to five times the annual gift tax exclusion of $15,000. This lump-sum gift can avoid federal gift tax if the gift is treated as having been made in equal installments over a five-year period and no additional gifts are made to that beneficiary during the five-year period. Five years later, another lump-sum gift can be made again in this manner, and so on.

Coverdell ESAs

A Coverdell Education Savings Account is a tax-advantaged college savings vehicle that lets you contribute up to $2,000 per year for your child's elementary, secondary, and college expenses. As with a 529 plan, qualified withdrawals from a Coverdell ESA are tax-free at the federal level (and typically at the state level, too), and the earnings portion of nonqualified withdrawals is subject to a 10% penalty. But unlike the case with a 529 plan, your ability to contribute is based on your modified adjusted gross income.

	Individuals	Married couples
To make a full $2,000 contribution in 2020, your income must be less than ...	$95,000	$190,000
To make a partial contribution in 2020, your income must be between ...	$95,000 and $110,000	$190,000 and $220,000

Roth IRAs

A Roth IRA is primarily a retirement savings vehicle but offers a benefit if used for college. Generally, there is a 10% early distribution penalty on the earnings portion of any withdrawal made before age 59½. But if the withdrawal is used to pay a child's college expenses, the 10% penalty is waived (provided you have held the account for at least five years). However, the earnings portion of the withdrawal would still be subject to income tax. Once you turn 59½, you can withdraw funds for *any* purpose with zero tax implications or penalties. In 2020, the maximum you can contribute to a Roth IRA is $6,000, or $7,000 if you are age 50 or older (this contribution limit is for traditional and Roth IRAs combined). But not everyone can contribute to a Roth IRA; your ability to contribute is based on your modified adjusted gross income.

	Individuals	**Married couples**
In 2020, to make a full $6,000 Roth contribution (or $7,000 if you are age 50 or older), your income must be ...	$124,000 or less	$196,000 or less
In 2020, to make a partial Roth contribution, your income must be between ...	$124,000 and $139,000	$196,000 and $206,000

Mutual funds and stocks

Many parents save for college by investing in mutual funds and stocks, or maybe exchange-traded funds, within a brokerage account. The main benefits are variety and flexibility — there are thousands of funds and stocks to choose from, and the proceeds can be used for any purpose, not just college. But these investments don't offer any tax advantages specific to college. Instead, consider holding them within a tax-advantaged account.

In 2020, the maximum you can contribute to a Roth IRA is $6,000, or $7,000 if you are age 50 or older (this limit is for traditional and Roth IRAs combined). But not everyone can contribute to a Roth IRA.

Note: All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.

Look at a variety of factors to choose the right college savings option for you.

Which Options Are Right for You?

Choosing the right college savings options involves taking into account your income, time horizon, and risk tolerance, along with your personal preferences on issues like tax benefits, investment control, and flexibility on use of funds. The following table compares some common college savings options.

	529 plans	Coverdell ESAs	Roth IRAs	Mutual funds & stocks
Open to anyone	Yes	No	No	Yes
High or no contribution limit	Yes	No	No	Yes
Full investment control	No	Yes	Yes	Yes
Tax-free earnings	Yes*	Yes*	Yes**	No
Flexibility	No	No	Yes	Yes
Excluded for financial aid purposes	No	No	Yes	No

* Earnings are tax-free only if the funds are used to pay the beneficiary's qualified education expenses. If the funds are used for a different purpose, then earnings are taxed at the income tax rate of the person making the withdrawal and are also subject to a 10% federal penalty.

** Earnings are tax-free if the withdrawal is made after age 59½ and a five-year holding period is met; the funds do not need to be used for college to be tax-free.

Financial Aid

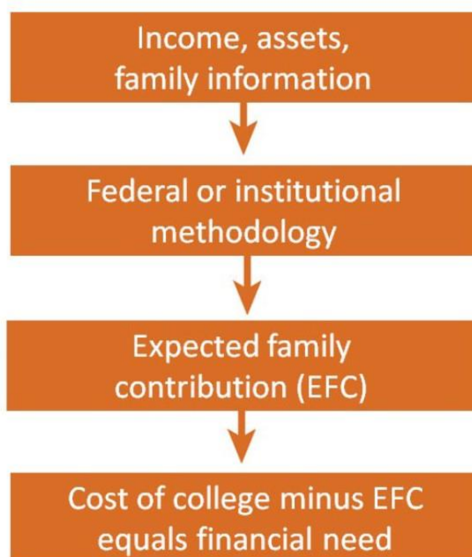
For many families, financial aid is the bridge that enables them to successfully meet college costs.

Financial aid is money given to students primarily by the federal government and colleges in the form of loans, grants, scholarships, and work-study. Loans and work-study must be repaid, either through a financial obligation or service to the college, while grants and scholarships do not. You want to maximize grants and scholarships while minimizing loans.

A college net price calculator, which is available on all college websites, can give you an estimate of how much grant aid your child might expect at a particular college. It requires income, asset, and general family information, and takes about 10 to 15 minutes to complete. It is a valuable resource!

How is financial need determined?

Each year, the federal government looks at your income, assets, and personal family information that you list on the FAFSA and calculates a figure called your expected family contribution, or EFC. The EFC is the amount of money the government deems you can afford to pay for college that year. Colleges typically do this same analysis using their own formula, which generally digs a bit deeper into your assets.



Your EFC remains the same no matter what college your child applies to. The difference between your EFC and the cost of a particular college is your child's financial need. Your child's financial need will be different at every college.

Your current income is the most important factor in determining your child's financial need, but other factors play a role, such as how many children you will have in college at the same time.

In its calculation, the federal government excludes some assets from consideration:

- Home equity
- Retirement accounts
- Annuities
- Cash value life insurance

Private colleges typically exclude retirement accounts, but may look at these other assets to get a full idea of your ability to pay.

Crafting an aid package

When your child is accepted at a particular college, the financial aid administrator at that school will look at your child's financial need and attempt to craft an aid package to meet that need. It can be met with a combination of federal loans, grants, and work-study along with college grants and/or scholarships. Colleges aren't obligated to meet all of your child's need. If they don't, you're responsible for that portion too, in addition to your EFC.

A word about loans

When you file the FAFSA, your child becomes eligible for certain federal loans. Some of these loans are based on financial need, but one loan (the Direct Unsubsidized Loan) is open to any student, regardless of need. All loans have annual borrowing limits. The student takes out the loan in his or her name and is responsible for paying it back.

In addition, parents with good credit histories can take out a federal PLUS Loan for up to the full cost of their child's education.

Beyond this, a parent might decide to co-sign on a private student loan, with the student as primary borrower. If you co-sign on a loan and your child can't pay back the loan after graduation, then you are on the hook.

But beware: Students and parents who borrow too much for college could end up with a considerable debt burden that can last for years after graduation. The key is to save as much as you can before college to limit the amount you might need to borrow come college time.

Evaluating Your Situation

Whether you're embarking on a new college savings program or enhancing an existing one, it's a good idea to take stock of where you are today.

College savings options

Which savings options do you already have? If you have more than one child, note the accounts and balances for each child.

	Child 1	Child 2	Child 3
529 plan			
Coverdell ESA			
Roth IRA			
Mutual funds & stocks			
Bank savings account			
Certificates of deposit			

Balancing saving for college and retirement

How you will balance college savings with your retirement savings? Ask yourself the following questions:

- Are you currently saving for retirement? If so, how much? Is your spouse?
- How many years away are you from retirement?
- Have you calculated your retirement income needs?
- If yes, what is your long-term retirement savings goal?
- Once you start saving for college, will you still be able to save the same amount for retirement?

Financial aid

How much do you know about financial aid? You should have an understanding of the following topics:

- The different types of financial aid: loans, grants, scholarships, work-study
- Main sources of financial aid
- Need-based aid vs. merit aid
- How your expected family contribution (EFC) is calculated
- The difference between your EFC and your child's financial need
- College net price calculators
- Loan options

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