

## HANDLING THE HIGHER COST OF HIGHER EDUCATION

*“Education costs money, but then so does ignorance.”*

– Sir Claus Moser

*By George Chamberlin*

The estimated cost of a four-year college education, including room and board, for a child born today, beginning college in 2021, is \$132,486 at a state institution, and \$288,402 at a private institution, according to a study by the Delaware Investments Group. These are sobering numbers, whether for a new parent or a person looking at funding education for a child or other family member in the near term.

How much will it take to finance the anticipated cost of education in just 18 - or fewer - years? What is the best way to go about investing for this planned expense? These and other related questions are asked of advisors every day. The answers depend a great deal on the preferences and desires of the individual investor.

One of the most highly touted techniques for funding higher education is the Section 529 plan. This plan features tax-deferred growth of sums set aside for education. The Section 529 plan became much more attractive with the passage of legislation in 2001 that made qualified plan distributions entirely federal income tax-free. (Note that state income tax treatment may not always parallel the generous federal income tax advantages of the Section 529 plan).

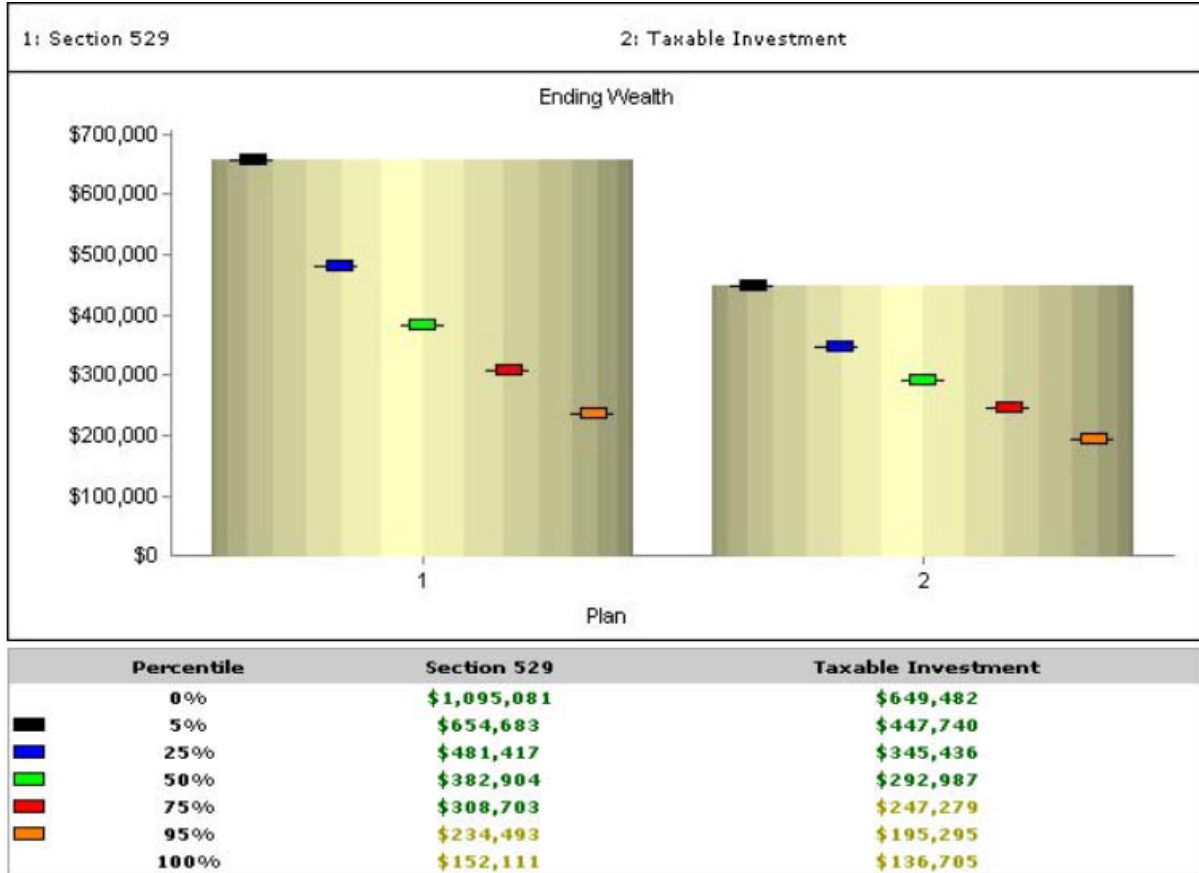
Contributions to a Section 529 plan are gifts by the donor to the student recipient. As long as the annual contribution does not exceed the annual gift tax exclusion, no gift tax will be due. Further, the value contained in such a plan is not included in the donor's taxable estate at death. This federal estate and gift tax treatment, when coupled with the generous income tax treatment accorded these plans, makes them an extremely attractive education funding technique.

There are no income limitations for making contributions to a Section 529 plan, and the plan is available to fund education at any accredited United States institution of higher learning, as well as many foreign institutions. Other features of the Section 529 plan include the donor's ability to change the student beneficiary and the ability to have multiple plans for any beneficiary. The plan may be implemented either through the purchase of credit hours at their current cost - the prepaid tuition plan - or through a college savings account.

*Section 529 plan compared to taxable investments*

What do these Section 529 facts mean for clients investing in their children's higher education? The answers vary depending on the time horizon and resources available. Our analysis will be based on the situation outlined above – funding the anticipated cost of four years in a private institution for a child born in 2002, a target of \$288,402. *Figure 1* provides a comparison of the ending values of a Section 529 plan and an ordinary taxable investment, each funded with \$7,500 annually from 2002 until 2021.

Figure 1: Comparison of Section 529 plan with taxable investment



The tremendous impact of tax-free growth and distribution in the Section 529 plan is obvious. The probability of success and potential ending value with the Section 529 plan are much higher than the plan that relies solely on a taxable investment.

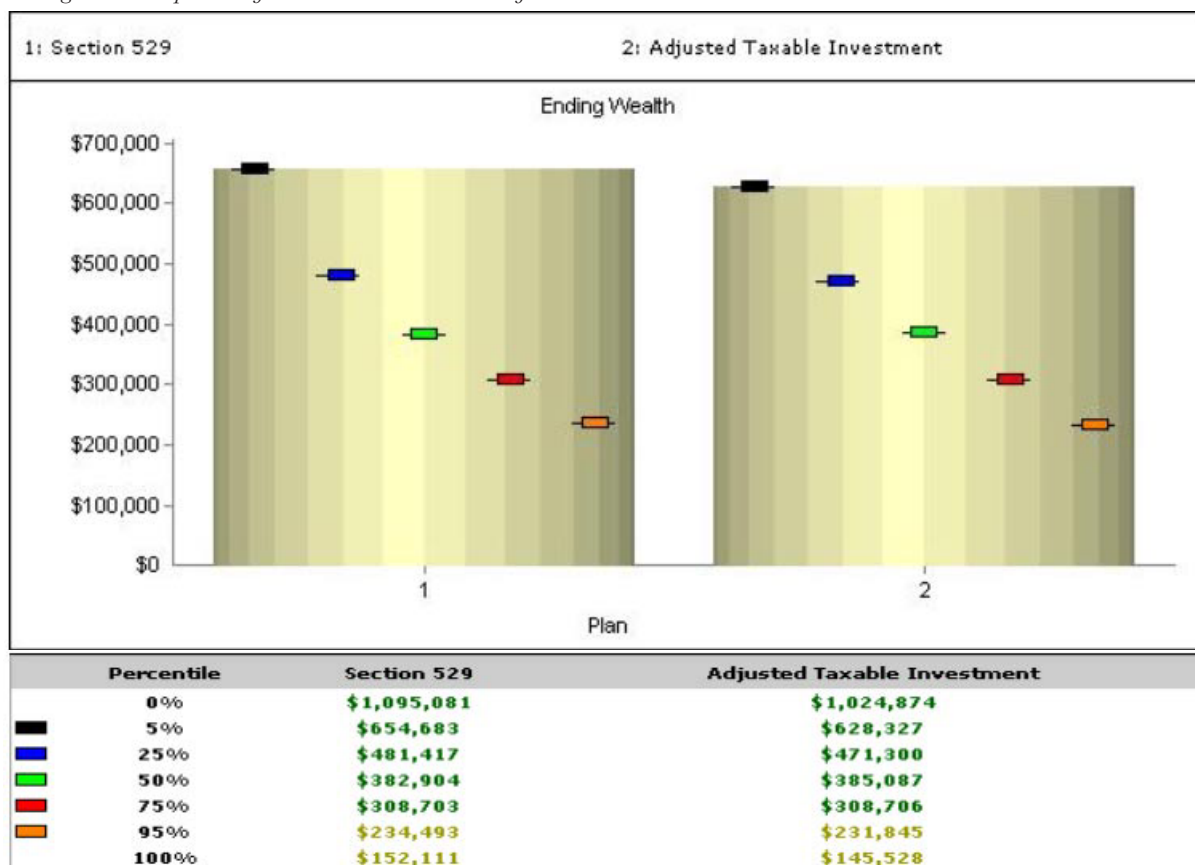
However, the very success of the Section 529 plan can lead to problems for the uninformed donor. Probably the most important issue involves how amounts in the plan above the actual need of the student beneficiary will be distributed. Although distributions for higher education expenses are tax-free, distributions for other purposes may result in income tax and penalties on the tax-deferred growth of the contributions in the plan. This adverse treatment applies even to distributions for elementary or secondary education, such as prep or parochial schools. However, the donor’s ability to change the designated beneficiary of the plan to another family member will be helpful in addressing this issue.

Advisors and donors should be aware of other potential constraints in some Section 529 plans. For example, some plans enforce limits on contributions to plans that have grown above a specified level – such as \$240,000 – and limit choices for asset allocation. These issues may be addressed by careful selection among available Section 529 plans such as a plan that offers desirable allocation choices or by changing allocations periodically within a plan.

Thus, although we can see that there are some potential drawbacks to the Section 529 plan, it appears that these issues will affect a minority of donors and are unlikely to provide most clients with a compelling reason to limit investment to taxable investments.

For a taxable investment to approximate the results obtained with the Section 529 plan it would be necessary to invest more money and/or apply a more aggressive allocation. In the following illustration (Figure 2), the annual contribution to the taxable investment was adjusted to \$9,000 and the allocation changed to the more aggressive balanced portfolio.

Figure 2: Comparison of Section 529 Plan with Adjusted Taxable Investment



The results illustrated in Figure 2 confirm that when education is the goal, the Section 529 plan is hard to beat. Even with a twenty percent increase in the contribution and a more aggressive allocation, the taxable investment can't measure up. Since the amount of cash available each year to be earmarked for education goals is often an issue with clients, this illustration provides a call to action for clients who are limited in their resources. Simply put, the Section 529 plan gives your clients "more bang for the buck."

*Using the Coverdell Education Savings Account*

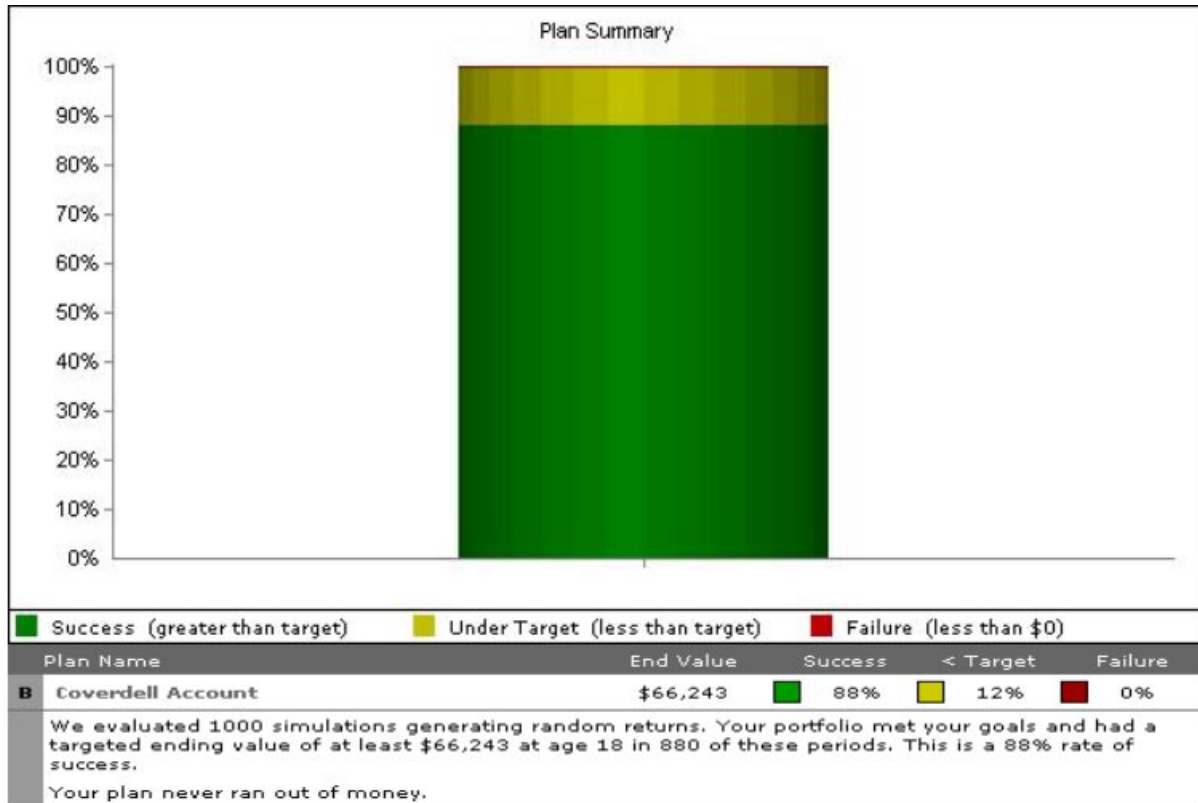
Another investment vehicle for education is the Coverdell Education Savings Account, formerly called the education IRA. Like the Section 529 plan, the Coverdell account provides for tax deferred growth and tax free distributions to fund education expenses. However, annual contributions to a Coverdell account are limited to \$2,000 and there are income limitations on the donors. This makes the Coverdell less attractive for some donors, particularly those who anticipate a higher cost of education such as that associated with attendance at a private institution.

A significant advantage of the Coverdell account is that distributions may be used for elementary and secondary education and are not limited to higher education as are distributions from the Section 529 plans.

This provides a planning opportunity for advisors and clients. Since clients may use both the Section 529 plan and a Coverdell account to fund education for the same child, there is great flexibility in funding education goals.

The utility of the Coverdell account may be significant, despite the limitations on contributions. The Delaware Investments Group study mentioned at the beginning of the article projected that a four-year education at a state institution would cost \$132,486 in 2021. If a client desired to fund half the anticipated cost of this education goal, beginning savings today, how would the Coverdell account perform? *Figure 3*

*Figure 3: Probability that contributions to a Coverdell account would fund state institution goal*



We see that a contribution of \$2,000 annually to a Coverdell account is very likely to fully fund the more modest education goal. *Figure 3* illustrates how a small, regular contribution makes a big difference. This enables clients to see that they may realize their dream of funding education, at least to some extent.

Naturally, using these alternative education funding techniques will have an impact on the client’s greater financial plan. Illustrating the techniques in isolation is helpful in determining which techniques will best meet the client’s goals. Adding the chosen techniques to the client’s total financial plan is essential to creating a meaningful – and workable – plan. It is only by adding the education planning to the overall financial plan that we can see the impact on our desired retirement goals.

Helping clients understand their options for fulfilling their education dreams. This is the future of financial advising.