Smart College Savings Strategies

Today, only about half of U.S. parents are saving for college. Of those savers, 88% are confident that they will achieve their objective; however, only 29% are actually on track to reach their college savings goal.[1] Additionally, only 37% of savers are utilizing the powerful tax-advantaged 529 Plan accounts.[1]

The reality of projected college costs is adding to the challenge. While the population of college applicants is growing rapidly, the number of top universities is not. This is driving college costs up much faster than the rate of inflation. For children born this year, four-year total costs are projected to be over $275,000 for in-state public colleges and over $420,000 for private colleges.[2]

With the rapid increase of college costs, saving for college can feel daunting. However, when addressed early and with the right strategy, saving for college can be reasonable while providing valuable tax breaks for the parents. In fact, with markets and many portfolios near all-time highs, now may be a great time to boost college savings strategies.

Start Early

As with retirement savings, the timing of college savings contributions is a more powerful factor than the amount. The chart below shows our minimum recommended contributions for college savings. As this chart shows, beginning earlier is far less painful than waiting.

Beginning early has two powerful mathematical advantages. First, the returns compound for a longer period. Second, expected annual returns are larger because the investments can be more aggressive at the outset due to a longer time horizon.

The chart on the following page uses several assumptions including historical distributions for stock and bond returns, and also factors how Sharper Granite would adjust allocation throughout the saving years. The contribution schedule targets in-state public colleges which represent the lower-cost end of college options. Private school costs are much higher than in-state college costs and are not represented on this chart.[2]

Finally, this chart assumes virtually all money grows and is withdrawn completely tax free. In reality, this requires careful planning, tracking, and managing over the years. This is where professional management can prove valuable.

Balance Tax Efficient Accounts

Of college savers, 63% do not utilize special tax-advantaged college savings accounts such as 529 plans.[1] How important is eliminating taxes during the college investment period? For a newborn, with an initial lump sum of $95,000 in a tax-advantaged account, the $275,000 savings target is reached after 19 years assuming a 6% annual return. In this example, only $95,000 of the final $275,000 is actually contributed by the family.[2] The remaining $180,000 comes from compounded, tax-free investment growth.

However, if the savings for college is held within a California-based parent's regular, taxable account, the same $95,000 initial lump sum only grows to approximately $202,000. During the 19 years of saving, $73,000 disappears to taxes.[2]

Several factors go into a well-designed college plan. These include the number of children; whether the children will attend private grade school; the parents' likelihood for receiving financial aid; and the parents' marginal tax rate.

Several account options exist for college savings and investment including UTMA accounts, 529 plans, and Coverdell accounts. Most of our recommended college savings strategies utilize some combination of the first two.

UTMA accounts have flexibility in that the money can be used for *any* benefit of the child, including private grade school. They also have tax advantages if appropriately managed each year. In these types of accounts, once money is assigned to a particular child it cannot be reassigned to another family member.

Minimum Suggested Contribution Plans [2]

Beginning Investment Age Today	Initial Lump Sum	Monthly Contrib	4-Yr College Funds at Age 19
Newborn	$0	$680	$275k
	$40k	$390	
	$75k	$130	
	$95k	$0	
5 Year Old	$0	$865	$215k
	$40k	$525	
	$75k	$225	
	$100k	$0	
10 Year Old	$0	$2,050	$165k
	$40k	$1,400	
	$75k	$850	
	$130k	$0	

529 plan accounts have far stronger tax advantages. In fact, 529 plan tax rules are similar to those of a Roth IRA. Pre-tax money deposited into 529 plans grows free of all taxes (capital gains tax, interest tax, and dividend tax); however, 529 plans are far less flexible than UTMA accounts. This money *must* be used for tuition expenses in connection with enrollment at an elementary or secondary public, private, or religious school or at a college, university or vocational schools. Money may be removed from the accounts prematurely or for other reasons, but similar to the Roth IRA rules, the gains are taxed along with an additional 10% penalty.

These plans can be helpful in overall financial planning as well. 529 plans may play a role in financial aid calculations, gifting strategies and estate planning. Contributions to 529 plans are assigned a lower asset weighting in financial aid calculations. The usual $14,000 per year gift exemption may be accelerated up to five years if the gift is made to a 529 plan. And 529 plans may also be used to bleed down estate values (thereby lowering estate taxes later) in that 529 gifts are considered to be revocable gifts.

Customize the Strategy

Well-designed strategies almost always involve contributing savings across UTMA accounts and 529 plans for the right combination of flexibility and tax savings. Because 529 plans may be reassigned to other family members, households with multiple children have additional flexibility in that they can pass down unused 529 plan money from their first child to younger children or grandchildren.

529 plans are offered by all 50 states, and most states have multiple plans, creating hundreds of options. Most states offer a state tax deduction to residents using their in-state plan. Unfortunately, California, where most of our clients live, does not offer that advantage. California residents should review plans from all states and choose the best one for them. We prefer Nevada's Vanguard plan for its low-cost fund choices and how well those fund choices map to our target portfolio design. The Nevada Vanguard 529 plan also consistently appears near the top of the annual rankings by Morningstar and SavingForCollege.com.

Once UTMA and 529 plan accounts are established, ongoing asset allocation and rebalancing is still required to maintain the target allocation while keeping tax effects low in the UTMA. Bonds and high-dividend stocks should be emphasized in 529 plans while low-dividend stocks should be weighted in the UTMA accounts. Also, annual harvesting of allowable tax-free capital gains in a UTMA account raises the cost basis of these accounts (which minimizes tax liabilities later) and takes advantage of the child's likely low tax rate.

We have helped many families put their kids through college, and we currently manage college savings plans for about a third of our client households. Your Sharper Granite advisor can help you develop a smart, tax-efficient college savings plan, while tracking progress from birth all the way through college.

Notes and Acknowledgements:

1. "How America Saves for College," annual Sallie Mae Survey, 2016
2. Sharper Granite analysis and *Annual Survey of Colleges in Trends in College Pricing, 2016*, CollegeBoard. Assumptions. "Four Year College Funds at Age 19" refers to expected 4-year in-state college total cost for a child beginning investment today at that corresponding age

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