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Harmony Wealth Strategies
BUILDING AND SAFEGUARDING YOUR FINANCIAL WORLD

Saving for College

A down payment

Most parents save only a portion of their child's education costs before college. Typically, they put aside enough money to make a down payment on the college bill (in the same way one might purchase a home), and then supplement this down payment at college time with other sources of income, including financial aid.

Sending Your Child to College

Sending a child to college is at the top of the wish list for most parents. A college education can open doors to many opportunities and help your child compete in today's competitive job market. But that diploma doesn't come cheap.

College costs

For the 2020-2021 school year, the average annual cost is: $26,820 for a four-year public college (in-state student), $43,280 for a four-year public college (out-of-state student), and $54,880 for a four-year private college. Total figures include tuition and fees, room and board, books, transportation, and personal expenses. Costs for the most selective private colleges are substantially higher. (Source: College Board, Trends in College Pricing and Student Aid 2020)

It's likely that costs will continue to rise, but by how much? Annual increases in the range of 3% to 5% would be in keeping with historical trends. But the actual percentage increase in any year could be higher or lower, and the rate could vary from public to private college.

How will I pay for it?

Year after year, thousands of students graduate from college. So how do they do it? Many parents save less than 100% of their child's education costs before college. Typically, they put aside enough money to make a down payment on the college bill (in the same way you might purchase a home). Then, at college time, parents supplement this down payment with:

- Current income
- Federal and college student-based financial aid (e.g., student loans, grants, scholarships, work-study)
- Investments (e.g., 529 plan, mutual funds)
- Child's savings and/or earnings from a part-time job
- Federal Parent PLUS Loan
- Home equity loan or other private loan
- Gifts from grandparents

How much should I save?

You'll want to save as much money as you can in your child's college fund. The more money you set aside now, the less you or your child will need to borrow later. Start by estimating your child's costs for four years of college. Then use a financial calculator to determine how much money you'll need to put aside each month or year to meet your goal. In many cases, the amount of money you set aside really comes down to how much you can afford to save. You'll need to take a detailed look at your finances. Every family's situation is different.

Start saving as early as possible

Perhaps the most difficult time to start a college savings program is when your child is young. New parents face many financial demands that always seem to take over — the possible loss of one income, child-related spending, the competing need to save for a house or car, or the demands of your own student loans. Yet this is the time when you should start saving.

When your child is young, you have time to select investments that have the potential to outpace college cost increases (though investments that offer higher potential returns may involve greater risk of loss). This table shows what a consistent monthly investment might grow to over a certain period of years.

Amount Invested	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: *Table assumes an annual 6% return. This is a hypothetical example and is not intended to reflect the actual performance of any investment. Rates of return will vary over time, particularly for long-term investments. Investments with the potential for higher rates of return also carry a greater degree of risk of loss. Fees and expenses are not considered and would reduce the performance shown if they were included.*

You'll also benefit from compounding, which is the process of earning additional returns on the interest and/or capital gains that you reinvest along the way. With regular investments spread over many years, you may be surprised at how much you might be able to accumulate in your college fund.

Don't worry if you can't save hundreds of dollars every month right from the beginning. Start with a small amount, and add to it whenever you can.

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The right combination

Ideally, you'll want to choose a college savings vehicle that offers the best combination of tax advantages, financial aid benefits, and flexibility, while meeting your overall investment needs.

Note on 529 plans

Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing; specific plan information is available in each issuer's official statement. There is the risk that investments may not perform well enough to cover college costs as anticipated. Also, before investing, consider whether your state offers any favorable state tax benefits for 529 plan participation, and whether these benefits are contingent on joining the in-state 529 plan. Other state benefits may include financial aid, scholarship funds, and protection from creditors.

Tax-Advantaged Ways to Save for College

In the college savings game, all strategies aren't created equal. Should you choose a 529 plan, a Coverdell account, a custodial account, or a mutual fund? The best savings vehicles offer special tax advantages if the funds are used to pay for college.

Tax-advantaged strategies are important because over time, you might be able to accumulate more money with a tax-advantaged investment compared to a taxable investment. (However, lower maximum tax rates for capital gains and dividends, as well as the tax treatment of investment losses, could make the investment return for a taxable investment more favorable.) Ideally, you'll want to choose a savings vehicle that offers the best combination of tax advantages, financial aid benefits, and flexibility, while meeting your overall investment needs.

529 plans

Since their creation in 1996, 529 plans have become to college savings what 401(k) plans are to retirement savings — an indispensable tool for saving money for a child's or grandchild's college education.

There are two types of 529 plans — savings plans and prepaid tuition plans. Though each is governed under Section 529 of the Internal Revenue Code (hence the name "529" plans), savings plans and prepaid tuition plans are very different savings vehicles.

529 savings plans

The more popular type of 529 plan is the savings plan. A 529 savings plan is a tax-advantaged savings vehicle that lets you save money for college and K-12 tuition in an individual investment-type account, similar to a 401(k) plan. Some plans let you enroll directly, while others require you to go through a financial professional.

The details of 529 savings plans vary by state, but the basics are the same. You'll need to fill out an application, name a beneficiary, and select one or more of the plan's investment portfolios to which your contributions will be allocated. Also, you'll typically be required to make an initial minimum contribution, which must be made in cash.

529 savings plans offer a unique combination of features that no other education savings vehicle can match:

Federal tax advantages: Contributions to a 529 account accumulate tax deferred and earnings are tax free if the money is used to pay the beneficiary's qualified education expenses. (The earnings portion of any withdrawal not used for qualified education expenses is taxed at the recipient's rate and subject to a 10% penalty.)

State tax advantages: Many states offer income tax incentives for state residents, such as a tax deduction for contributions or a tax exemption for qualified withdrawals. However, be aware that some states limit their tax deduction to contributions made to the in-state 529 plan only.

High contribution limits: Most plans have lifetime contribution limits of $350,000 and up (limits vary by state).

Unlimited participation: Anyone can open a 529 savings plan account, regardless of income level.

Wide use of funds: Money in a 529 savings plan can be used to pay the full cost (tuition, fees, room, board, books, supplies) at any accredited college or graduate school in the United States or abroad; for certified apprenticeship programs (fees, books, supplies, equipment); for student loan repayment (there is a $10,000 lifetime limit per 529 plan beneficiary and $10,000 per each of the beneficiary's siblings); and for K-12 tuition expenses up to $10,000 per year.

Professional money management: 529 savings plans are offered by states, but they are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios.

Flexibility: Under federal rules, you are entitled to change the beneficiary of your account to a qualified family member at any time as well as roll over (transfer) the money in your account to a different 529 plan once per calendar year without income tax or penalty implications.

Accelerated gifting: 529 savings plans offer an estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's education while paring down their own estate, or a way for parents to contribute a large lump sum. Under special rules unique to 529 plans, a lump-sum gift of up to five times the annual gift tax exclusion amount ($15,000 in 2021) is allowed in a single year, which means that individuals can

Two types of 529 plans

A 529 savings plan lets you save money for college or K-12 tuition in an individual investment-type account. A 529 prepaid tuition plan lets you prepay college tuition at participating colleges at today's prices for use in the future.

make a lump-sum gift of up to $75,000 and married couples can gift up to $150,000. No gift tax will be owed, provided the gift is treated as having been made in equal installments over a five-year period and no other gifts are made to that beneficiary during the five years.

Transfer to ABLE account: 529 account owners can roll over (transfer) funds from a 529 account to an ABLE account without federal tax consequences. An ABLE account is a tax-advantaged account that can be used to save for disability-related expenses for individuals who become blind or disabled before age 26.

Variety: Currently, there are over 50 different savings plans to choose from because many states offer more than one plan. You can join any state's savings plan.

But 529 savings plans have a couple of drawbacks:

No guaranteed rate of return: Investment returns aren't guaranteed. You roll the dice with the investment portfolios you've chosen, and your account may gain or lose value depending on how the underlying investments perform. There is no guarantee that your investments will perform well enough to cover college costs as anticipated.

Investment flexibility: 529 savings plans have limited investment flexibility. Not only are you limited to the investment portfolios offered by the particular 529 plan, but once you choose your investments, you can only change the investment options on your existing contributions twice per calendar year. (However, you can generally direct how your *future* contributions will be invested at any time.)

529 prepaid tuition plans

Prepaid tuition plans are cousins to savings plans — their federal tax treatment is the same, but their operation is very different. A 529 prepaid tuition plan lets you prepay tuition at participating colleges, typically in-state public colleges, at today's prices for use by the beneficiary in the future. Prepaid tuition plans are generally limited to state residents, whereas 529 savings plans are open to residents of any state. Prepaid tuition plans can be run either by states or colleges, though state-run plans are more common.

As with 529 savings plans, you'll need to fill out an application and name a beneficiary. But instead of choosing an investment portfolio, you purchase an amount of tuition credits or units, subject to plan rules and limits. Typically, the tuition credits or units are guaranteed to be worth a certain amount of college tuition in the future, no matter how much college costs may increase between now and then.

However, if your child ends up attending a college that doesn't participate in the plan, prepaid plans differ on how much money you'll get back. Also, some prepaid plans have been forced to reduce benefits after enrollment due to investment returns that have not kept pace with the plan's offered benefits.

Even with these limitations, some college investors appreciate not having to worry about college inflation each year and want to lock in college tuition prices today. The following table summarizes the main differences between 529 savings plans and 529 prepaid tuition plans:

529 savings plans	529 prepaid tuition plans
Offered by states	Offered by states and private colleges
You can join any state's plan (though some plans may require you to enroll with a financial professional)	State-run plans require you to be a state resident
Contributions are invested in your individual account in the investment portfolios you have selected	Contributions are pooled with the contributions of others and invested by the plan
Returns are not guaranteed; your account may gain or lose value depending on how the underlying investments perform.	Generally a certain rate of return is guaranteed in the form of a percentage of tuition being covered in the future, no matter how much costs may increase by then
Funds can be used for a wider range of expenses, including the full cost of college or graduate school in the U.S. or abroad, apprenticeship programs, student loan repayment, and K-12 tuition expenses	Funds can be used only for tuition at participating colleges (typically state colleges); room and board and graduate school generally are not eligible expenses

College and K-12

A Coverdell education savings account is a tax-advantaged education savings vehicle that lets you save money for college or K-12 at public, private, or religious schools.

Coverdell education savings account

A Coverdell education savings account (Coverdell ESA) is a tax-advantaged education savings vehicle that lets you save money for college, plus elementary and secondary school (K-12) at public, private, or religious schools. Here's how it works:

Application process: You fill out an application at a participating financial institution and name a beneficiary. There may be fees associated with opening and maintaining the account. The beneficiary must be under age 18 when the account is established (unless he or she is a child with special needs).

Contribution rules: You (or someone else) make contributions to the account, subject to the maximum annual limit of $2,000. This means that the total amount contributed for a particular beneficiary in a given year can't exceed $2,000, even if the money comes from different people. Contributions can be made up until April 15 of the year following the tax year for which the contribution is being made.

Investing contributions: You invest contributions as you wish (e.g., stocks, bonds, mutual funds, certificates of deposit) — you have sole control over your investments.

Tax treatment: Contributions to your account grow tax deferred, which means you don't pay income taxes on the account's earnings (if any) each year. Money withdrawn to pay college or K-12 expenses (a qualified withdrawal) is completely tax free at the federal level and at the state level too. If the money isn't used for college or K-12 expenses (a nonqualified withdrawal), the earnings portion of the withdrawal will be taxed at the beneficiary's tax rate and subject to a 10% federal penalty.

Rollovers and termination of account: Funds in a Coverdell ESA can be rolled over without penalty into another Coverdell ESA for a qualifying family member. Also, any funds remaining in a Coverdell ESA must be distributed to the beneficiary when he or she reaches age 30 (unless the beneficiary is a person with special needs).

Not everyone can open a Coverdell ESA — your ability to contribute depends on your income. To make a full contribution, single filers must have a modified adjusted gross income (MAGI) of less than $95,000 and joint filers must have a MAGI of less than $190,000.

Custodial accounts

Before 529 plans and Coverdell ESAs, there were custodial accounts. A custodial account allows your child to hold assets — under the watchful eye of a designated custodian — that he or she ordinarily wouldn't be allowed to hold in his or her own name. The assets can be used to pay for college or anything else that benefits your child (e.g., summer camp, a computer). Here's how it works:

Application process: You fill out an application at a participating financial institution and name a beneficiary. There may be fees associated with opening and maintaining the account.

Custodian: You designate a custodian to manage and invest the account's assets. The custodian can be you, a friend, a relative, or a financial institution. The assets in the account are controlled by the custodian.

Assets: You (or someone else) contribute assets to the account. The type of assets you can contribute depends on whether your state has enacted the more common Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA). Examples of assets typically contributed are stocks, bonds, mutual funds, and real property.

Tax treatment: Earnings, interest, and capital gains generated from assets in the account are taxed every year to the child under special "kiddie tax" rules that apply when a child has unearned income. The kiddie tax generally applies to children under age 18 and full-time college students under age 24 whose earned income doesn't exceed one-half of their support. Under the kiddie tax rules, a child's unearned income over a certain threshold ($2,200 in 2021) is taxed using parent income tax rates.

In addition to the kiddie tax rules, there are other drawbacks too: all gifts to a custodial account are irrevocable, and money can only be withdrawn for the child's benefit. Also, when the child reaches the age of majority (either 18 or 21, depending on state law), the account terminates and the child gains full control of all the assets in the account.

A "qualified education expense"

To be tax free at the federal level, the investment funds of certain savings vehicles have to be used for "qualified education expenses." Surprisingly, this can mean different things depending on the savings vehicle.

U.S. savings bonds

Series EE and Series I bonds are types of savings bonds issued by the federal government that offer a special tax benefit for college savers. The bonds can be easily purchased from most neighborhood banks and savings institutions, or directly from the federal government. They are available in face values ranging from $50 to $10,000. You may purchase the bond in electronic form at face value or in paper form at half its face value.

If the bond is used to pay qualified education expenses and you meet income limits, the bond's earnings are exempt from federal income tax. (The bond's earnings are always exempt from state and local tax.) In 2021, to be able to exclude all of the bond interest from federal income tax, married couples must have a modified adjusted gross income of $124,800 or less at the time the bonds are redeemed (cashed in), and individuals must have an income of $83,200 or less. A partial exemption of interest is allowed for people with incomes slightly above these levels.

The bonds are backed by the full faith and credit of the federal government as to the timely payment of principal and interest, so they are considered a relatively safe investment. They offer a modest yield, and Series I bonds offer an added measure of protection against inflation by paying you both a fixed interest rate for the life of the bond (like a Series EE bond) and a variable interest rate that's adjusted twice a year for inflation. However, there is a limit on the amount of bonds you can buy in one year, as well as a minimum waiting period before you can redeem the bonds, with a penalty for early redemption.

Roth IRAs

Though technically not a college savings account, some parents use Roth IRAs to save and pay for college. In 2021, you can contribute up to $6,000 per year ($7,000 if age 50 or older). Earnings in a Roth IRA accumulate tax deferred. Contributions to a Roth IRA can be withdrawn at any time and are always tax free. For parents age 59½ and older, a withdrawal of earnings is also tax free if the account has been open for at least five years. For parents younger than 59½, a withdrawal of earnings — typically subject to income tax and a 10% premature distribution penalty — is spared the 10% penalty if the withdrawal is used to pay for a child's college expenses.

Not everyone is eligible to contribute to a Roth IRA, though — it depends on your income. To contribute the full $6,000 in 2021, your MAGI must be $125,000 or less if your filing status is single or head of household and $198,000 or less if you're married and file a joint return.

Qualified education expenses

To be tax free at the federal level, investment funds have to be used for "qualified education expenses." Surprisingly, this can mean different things depending on the savings vehicle.

529 savings plans: Qualified education expenses for 529 savings plans include the full cost of tuition, fees, room and board, books, equipment, and computers for college and graduate school; the cost of certified apprenticeship programs (fees, books, supplies, equipment); principal and interest payments on a qualified student loan (there is a $10,000 lifetime limit per 529 plan beneficiary and $10,000 per each of the beneficiary's siblings); and K-12 tuition expenses up to $10,000 per year for enrollment at an elementary or secondary public, private, or religious school (excluding homeschooling).

Room and board is a qualified expense only if the student is enrolled at least-half time. If the student lives on campus, room and board is limited to the actual amount charged by the school; if the student lives off campus or at home, room and board is limited to the college's specific published room and board allowance figure. Also, *special needs services* are a qualified expense only if they are incurred by a beneficiary with special needs in order to enroll or attend.

529 prepaid tuition plans: Qualified education expenses for 529 prepaid tuition plans generally include just tuition and fees for college only (not graduate school) at the colleges that participate in the plan.

Coverdell ESAs: Qualified education expenses include college and K-12 expenses and cover tuition, fees, room and board, books, equipment, computers, tutoring, uniforms, and transportation.

U.S. savings bonds: Qualified education expenses include tuition and fees for college, plus contributions to 529 plans and Coverdell ESAs. Room and board, books, equipment, and computers are not qualified education expenses.

What counts most in needs analysis?

Your current income is the most important factor in determining need, but other factors play a role, including your total assets and how many family members are in college at the same time.

Financial Aid

Financial aid is money distributed primarily by the federal government and colleges in the form of student loans, grants, scholarships, and work-study jobs. Loans and work-study must be repaid (through monetary or work obligations), while grants and scholarships do not. A student can receive both federal and college aid.

Financial aid can be further broken down into two categories: need-based, which is dependent on your child's financial need, and merit-based, which is awarded on the basis of academic, athletic, musical, or artistic merit.

Both the federal government and colleges provide need-based aid. The amount of federal aid available in any given year depends on the amount appropriated in the federal budget, and this aid is spread over different financial aid programs. For colleges, need-based aid comes from a college's endowment, and policies may differ from year to year and from college to college, which may result in an uneven availability of funds.

Colleges are the main source of merit aid, and they often use favorable merit aid packages to attract the best and brightest students to their campuses, regardless of their financial need. Every college has a net price calculator on its website that you can use to get an idea of how much aid (need-based and merit) your child might be eligible for at that particular college. If you're a family of means researching college options, one of the things you can do to help your bottom line is to target colleges that offer significant merit aid packages.

The financial aid impact

The college savings decisions you make can impact the needs-based financial aid process. Come financial aid time, your family's income and assets are run through a formula at the federal level (and at the college level for institutional aid) to determine how much money your family should be expected to contribute to college costs before you are eligible for financial aid. This process is called needs analysis, and the resulting figure is known as your expected family contribution, or EFC. Your income is by far the most important factor, but your assets count too.

The difference between your EFC and the cost of attendance at any given college equals your child's financial need. Your EFC remains a constant, but the amount of your child's financial need will vary depending on the cost of attendance at the underlying college. The higher your EFC, the less needs-based aid your child will be eligible for.

Under the federal methodology, student assets are weighed differently than parent assets. Students must contribute 20% of their assets each year, while parents must contribute 5.6% of their assets. For example, $10,000 in your child's bank account would equal an expected contribution of $2,000 from your child ($10,000 x.20), but the same $10,000 in your bank account would equal an expected $560 contribution from you ($10,000 x.056).

Under the federal rules, 529 plans and Coverdell ESAs are generally considered parental assets if the parent is the account owner. This is also true for mutual funds, stocks, bonds, U.S. savings bonds, certificates of deposit, real estate, and any other investment that may be owned by the parent. Exceptions under the federal methodology are retirement plans (e.g., 401(k) plans, Roth IRAs, 403(b) plans) cash value life insurance, and home equity — these assets are never counted, even if they are owned by the parent. By contrast, a custodial account is classified as a student asset.

If a grandparent is the account owner of a 529 plan or Coverdell account, the account isn't counted as an asset at all, but any withdrawals from the account are counted as student income, which is assessed at 50%. This could potentially cut a student's aid in half the following year. Withdrawals from parent-owned 529 plans and Coverdell accounts are not counted as student income at all.

How much should I rely on aid?

Some parents assume that financial aid will do most of the heavy lifting when it comes time to paying the college bills. But the reality is you shouldn't rely too much on financial aid. Although it can certainly help cover your child's college costs, student loans often make up the largest percentage of the typical aid package, not grants and scholarships. Remember, parents and students who rely mainly on loans to finance college can end up with a considerable debt burden that can have negative implications for years after graduation.

College Savings Vehicles Compared

	529 Plans	Coverdell ESAs	U.S. Savings Bonds	Custodial Accounts
Participation restrictions	No, though state-run prepaid tuition plans are generally limited to state residents	Yes, income limit for contributions and $2,000 maximum annual contribution per child	No, but ability to exclude bond proceeds from federal income tax depends on income	No
Control of underlying investments	No	Yes	Yes	Yes
Federal tax-free withdrawals if funds used for qualified education expenses	Yes (withdrawals may also be exempt from state income tax, depending on state law)	Yes (withdrawals may also be exempt from state income tax, depending on state law)	Yes, but income limits and other requirements must be met (bond proceeds are also generally exempt from state income tax)	No, taxed according to kiddie tax rules
Penalty if funds not used for qualified education expenses	Yes, a 10% federal penalty applies to the earnings portion of all nonqualified withdrawals (a state penalty may also apply)	Same as 529 plans	No, but the bond proceeds won't be exempt from federal income tax	No, but withdrawals from the account can only be made for the child's benefit
Federal financial aid treatment (student assets are weighed more heavily than parent assets)	Parent asset, if parent or student is account owner, or if 529 plan was funded with custodial account funds	Parent asset, if parent is account owner	Parent asset, if parent is owner of bonds	Student asset
Fees and expenses	529 savings plans: may be an annual administration fee and ongoing investment expenses 529 prepaid tuition plans: may be an enrollment fee and administrative fees	May be fees associated with opening and/or maintaining an account, depending on financial institution	No fees or expenses, except for the possibility of brokerage fees if bonds are purchased through a broker	May be fees associated with opening and/or maintaining an account, depending on financial institution

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing; more information is available in each issuer's official statement. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. Also, before investing, consider whether your state offers any favorable state tax benefits for 529 plan participation, and whether these benefits are contingent on joining the in-state 529 plan. Other state benefits may include financial aid, scholarship funds, and protection from creditors.*

The availability of the tax and other benefits mentioned above may be conditioned on meeting certain requirements. U.S. savings bonds are guaranteed by the federal government as to the timely payment of principal and interest. The remaining types of college savings vehicles discussed are not guaranteed (except for 529 prepaid tuition plans) and are more risky.

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