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Savings Options for College

Q. My twins just had a bat mitzvah and each received approximately $17,000. I want to invest this money for them so it won't impact their application for financial aid when the time comes. What are the best options?
— Dad

A. Mazel tov! And mazel tov to you for being careful with how you invest this money. When it comes to financial aid possibilities, putting money in the wrong kinds of accounts can hurt you. Assets of both parents and children are used to calculate the Expected Family Contribution (EFC) on the Free Applications for Student Aid (FAFSA) and the College Scholarship Services (CSS) profile.

In general, it is more favorable to have assets held by parents as they are only expected to contribute up to 5.64 percent of the value in the EFC calculation, said **Claudia Mott, a certified financial planner with Epona Financial Solutions in Basking Ridge**. Mott said this would exclude retirement accounts such as 401(k)s and IRAs.

"Tax-deferred accounts designed for higher education such as 529s and Education Savings Accounts (ESAs) — which also go by the name of Coverdells — are considered the asset of the parent even though the child's name may be on the account," Mott said.

A full 20 percent a child's assets will be used in the financial aid formula, she said, so you may decide that it is best to set up accounts that are titled in your name rather than your children's. If a parent-owned account is the right option, you may wish to consider a 529 college savings plan. These provide tax-deferred growth on income and earnings that accrue over the child's lifetime and a variety of different investment options. "Withdrawals for qualified education costs are free federal income tax," Mott said. "However, there is a 10 percent penalty and applicable federal income tax on any earnings that are withdrawn and used for non-college related expenses."

Mott said the maximum contribution that can be made by an individual into a 529, without a gift tax return, is $14,000 each year. But, a 529 can be funded with up to $70,000 in a lump sum and the reporting of the gift is spread over five years. A Coverdell ESA is another tax-deferred savings vehicle, but the maximum contribution that can be made by an individual each year is only $2,000, Mott said. "Contributions to these accounts can be tax deductible but there are income limitations," she said. "Like a 529, there is no penalty for using the funds in a Coverdell for qualified education expenses."

Beyond these tax-deferred options, you could use a taxable investment account, Mott said. But these accounts would be subject to possible taxes on the dividends, interest and capital gains that accrue each year and could be costly options relative to the 529 or the Coverdell. "Before you set up a 529 or a Coverdell, use an online calculator to test the EFC calculation to determine if you are likely to qualify for aid or speak with a professional who provides financial aid counseling," Mott said. "If your family's financial profile is one which may not generate any need-based financial aid, you may wish to consider opening accounts in your children's names."

We also want to mention Uniform Gift to Minor (UGMA) and Uniform Transfer to Minor Act (UTMA) accounts. These enable an adult to gift financial or other assets to a minor. The UGMA account can hold bank deposits, securities such as mutual funds and insurance, Mott said. An UTMA account allows almost any type of asset including real estate. Mott said both UGMA and UTMA accounts are considered the asset of the child, even though the custodian is an adult, and the annual contribution that can be made without the donor filing a gift tax return is $14,000.

"One of the disadvantages of these accounts for college savings relates to the taxation of unearned income," she said. "Up to $1,000 of income is exempt and the second $1,000 is taxed at the child's rate, but beyond $2,000, the 'kiddie' tax applies, which is the higher of the child's or parent's rate."

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