Top 5 Mistakes Parents Make Saving for Their Child’s Education

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.
Parents want the best for their children. And for many, that means the potential benefits that a college education can deliver – a promising career and the enhanced earnings potential that comes from higher education. However, the costs associated with pursuing a college degree have been on the rise. Tuition has been growing at a faster pace than inflation for many years. For example, for the 2012-2013 academic year, the net price (the cost after scholarships, grants, and federal tax benefits) rose 4.6% to $16,510 for in-state students attending public colleges while the net price for a four-year private school rose 5.6% to an average of $27,600.1

To compound the problem, many young people choose to return to school to earn a second degree after facing a challenging job market. Returning to school can exacerbate the issues associated with funding college education costs and mounting student debt load.

**Top 5 Mistakes Parents Make Saving for their Child’s Education**

With these increasing costs in mind, what are your options to help fund your child’s education? Most parents will do whatever it takes to set their kids on the path to a promising future. Even though the recent economic downturn has led to higher unemployment rates for college graduates, now close to 7%, those with only a high school degree have an unemployment rate of 24%. Further proving the value of a college education, college graduates earn twice as much as high school graduates.2

Setting aside enough to cover the costs of your child’s college degrees without putting other priorities such as retirement or cash flow at risk requires careful planning. For instance, by the time a child is in high school the savings plan for the child’s college education should be nearly complete. To achieve this savings goal without jeopardizing your own future financial security, a good starting point is to begin with a clear vision and understanding of your child’s future higher education costs adjusted for inflation. In other words, start with a financial plan that incorporates education funding for your children. Only once you have a clear plan can you begin to take proactive steps to secure this vision effectively through a savings plan and budgeting plan that maximizes...
all strategies available to you. In conjunction with the plan, parents should be aware of the five common mistakes to avoid when saving for college:

1. **Waiting too long**

   With many other competing financial commitments, it can be hard for parents to save for their child’s education. The sooner you start to invest, the longer your money has time to grow. The power of starting early and making consistent contributions to your child’s education savings plan cannot be overstated because of the power of compounding. The longer your money is invested, the harder it works for you. Give your contributions time to grow and produce results.

The Benefits of Investing Early

The graph above compares Scenario 1, where the parents contribute $2,500 per year for 12 years starting from birth, with Scenario 2, where the parents start at age 12 and contribute $5,000 for 6 years. In both cases, the parents have invested $30,000, but the compounding of returns over time provides the college fund in Scenario 1 with a much higher balance. Therefore, it is important to set up a plan as soon as the baby is born, ideally as soon as you get their social security number. Once the account is set-up, then you will be more likely to fund it.
2. Not contributing consistently

Every little bit helps. For example, a $100 per month periodic investment into a 529 plan for 18 years at a 6% growth rate (compounded monthly) would be worth $38,735. Most families can find $100 per month to save from their budget by cutting non-essentials. Ideally, you should consider implementing a simple “set it and forget it” approach that automates the education savings process with a periodic investment plan which makes regular pre-authorized contributions to your college savings plan. Also, instead of having relatives buy the newest electronic gadget for holidays and birthdays for your child, ask them to make a contribution to your child’s education fund instead. Your child may not appreciate it now, but they will thank you when they are 18. Grandparents generally adore their grandchildren, maybe even more than their own kids, and can sometimes be in a better position to financially support college contributions. Whatever the source, strive to make periodic investments to your child’s college plan.

3. Not taking advantage of 529 college education plans

The most popular vehicle to save for college education is the 529 plan, named after the section of the Internal Revenue Service (IRS) tax code that it comes from. Assets in 529s grew from $11 billion in 2002 to $179 billion as of June 30, 2012, with an average account balance of $16,298. There are two types – the prepaid tuition and a state-sponsored savings plan. For the purpose of this report, we will focus on the savings plan.

The 529 savings plan has many benefits:

**Tax Benefits:**

- 529 assets grow tax-deferred, and can be withdrawn tax-free as long as the funds are used for qualified education expenses. In this way, the power of compounding is maximized without any annual tax bite or tax reduction when used to pay for college and college related expenses.
- With the 2013 gifting amount set at $14,000, this means that parents or grandparents can make a contribution of up to $14,000 to the 529 plan assets can be withdrawn tax free as long as they are used for qualifying education expenses.
plan without the amount being subject to gift tax, or even accelerate the gift for 5 years, for a maximum contribution of $70,000 per child per account owner (or $140,000 for a couple, married filing jointly). This can grow to a significant amount that, if done early, can set your child on course to attend most schools without taking on significant future debt. Although it varies by plan, many allow in excess of $300,000 in total contributions.\(^4\)

- If you contribute to the 529 sponsored by the state in which you reside, you are typically eligible for a tax deduction on your state income taxes. As all states have a 529 plan, you have the option to open the plan in the state of your choice based on the plan that offers the features and funds you prefer most.

**Investment Choices:**

- Each 529 plan offers different mutual fund options, but typically there is a wide variety of investment fund choices, including age-based models. Despite being limited in the amount of changes you can make per year (unlike some other college savings vehicles), this is arguably less of a disadvantage because it minimizes attempts to time the market which historically has been counter productive.

**Eligibility for Financial Aid:**

- Since for 529 plans the parent (or grandparent) is the owner of the 529 plan account, you will maintain control of the assets which can be beneficial for financial aid considerations as well as ensuring that the funds are used for college. Parental assets are assessed at a maximum rate of 5.64% in determining the family’s Expected Family Contribution. Using a simplified example, if there is $20,000 in the 529 plan when it comes time to file the aid application, the child’s eligibility for federal financial aid can be decreased by no more than $1,128 ($20,000 x 5.64%).\(^5\) Alternatively, when a student owns assets, the calculation uses a maximum rate of 20% instead.
Flexibility:

- You can change beneficiaries since you, as the parent, are the account owner. If your first child doesn’t go to college or use all of their funds, the account beneficiary can be switched to a second child, yourself, or anyone who is a relative of your child (i.e. the initial beneficiary).

- 529 plans can be used at more than just four-year public and private colleges and universities. For example, they can be used for vocational and technical schools, community colleges, and graduate schools. Technically, qualifying institutions are all post-secondary schools that are eligible to participate in US Department of Education financial-aid programs.

- Your savings in a 529 plan cover more than just tuition expenses. They can be used for fees, room and board, textbooks, and necessary school supplies. It’s important to be aware, however, that if a 529 plan is not used for qualified education costs, withdrawals are subject to federal and state income tax and a 10% federal tax penalty on the earnings.

4. Not being aware of all the college savings options

Although 529 plans are the most common college savings plan, it is important to be aware of other education saving accounts available to you. There are several options for you to consider, with each having its own advantages and disadvantages when compared to the 529 plan.

1. Coverdell account

Another vehicle for college savings is the Coverdell Education Savings Account (“ESA”). ESAs share several of the advantages of 529s: assets grow tax-deferred and distributions are tax-free as long as they are for qualified education expenses; and beneficiaries can be changed. However, your contributions for each beneficiary cannot exceed $2,000 per year per beneficiary under age 18, which may limit your ability to save sufficient funds to cover several years of college expenses. In addition, in order for you to contribute the maximum to an ESA, there are income limits - $95,000 for single filers and $190,000 for married filing jointly.
Advantages include more investing options as the assets in the Coverdell can be set-up in a brokerage account (e.g. stocks, bonds, ETFs are all available choices), the ability to make unlimited changes to asset allocation, and to use the funds for K-12 education expenses. Note that you can have both a 529 and a Coverdell for the same child, and can even roll a Coverdell into a 529 plan.6

2. UGMA/UTMA accounts
UGMA (Uniform Gift to Minors Act) and UTMA (Uniform Transfer to Minors Act) are custodial accounts that you can set-up to save for your children’s college. However, the popularity of 529 plans trumped these accounts partly due to the fact that when your child reaches the age of majority in their state (18 or 21 depending on the state) your child gets control of the funds – which some parents may not consider a desirable outcome. If they choose to buy a car or follow a band around the country for a year with those assets, then it is their right to do so. Also, because the child owns the assets at the age of majority, these are assessed at a maximum rate of 20% for financial-aid calculations. Lastly, they do not grow tax-free like 529 plans. However, one of their advantages is that money can be used for expenses other than college. Another advantage is that investment options are numerous - stocks, bonds, mutual funds, and even real estate in the case of UTMAs.

These accounts have been around for a long time, and owners may want to consider transferring to what is known as a custodial 529 plan (or UGMA/UTMA 529). The assets must transfer in custodial form, and your child will still obtain control at the age of majority (18 or 21, depending on your state). In addition, it’s important to be aware that the assets will have to transfer as cash, which means that capital gains taxes may apply when holdings are sold. However, the advantages for the custodial 529 plan are that assets will grow tax-deferred, distributions for education will be tax-free, and for financial-aid purposes the calculation would be at the parent’s rate of 5.64% instead of 20%.7
3. Trust accounts
Although the use of these accounts has also reduced with the growth of 529 plans, some parents/grandparents may consider a Crummey trust or a 2503(c) trust to save for college even though they are taxable accounts and typically more expensive to set up.

A 2503(c) Trust is an irrevocable trust created to receive annual exclusion gifts for the benefit of a minor. Until the beneficiary reaches age 21, the trust principal and income may be expended for his or her benefit, including paying higher education expenses. At age 21, the beneficiary must be given the opportunity to withdraw assets from the trust. Most 2503(c) Trusts give the beneficiary a window of time (typically 30 – 90 days) to withdraw the assets. If the beneficiary does not exercise his or her right of withdrawal, the assets may be retained in trust until the beneficiary reaches some other defined distribution date. Earnings of the Trust are taxed at the trust income tax rates, unless the income is distributed to the beneficiary, in which case it is taxed at the beneficiary’s tax rate.

Crummey trusts are another type of irrevocable trust that are established to receive annual $14,000 gifts. This trust includes an annual withdrawal power that applies whenever a gift is made to the trust. Accordingly gifts are considered to be transfers of a present interest and qualify for the annual gift tax exclusion. Crummey trusts (named after the court case that approved this gifting technique) are more flexible than 2503(c) trusts. No withdrawal rights are required at age 21, trust distributions can be for any specified purpose and may be limited to just education expenses, and multiple beneficiaries can be named under a single trust document.

5. Not managing the child’s college decision
Although the school selection decision does not come into play until later, many parents let their children drive the process of selecting a college, often resulting in a school being selected that is too expensive for the family and less than optimal for future employment opportunities.
Therefore, two key factors to keep in mind include affordability and best value from an employment perspective.

When engaging your adult child about the school selection decision, it may help to take the time to educate them about both the cost of attending college and about keeping student debt to a minimum. For the class of 2011, the average student loan debt rose to almost $27,000. Should your child experience difficulty finding employment shortly after graduation, accumulating significant student debt compounds the financial problem that comes with being unemployed. Alternatively, if they find employment shortly after graduation, but graduate with minimal or no student debt, they will have the added opportunity of beginning to save and accumulate more funds to achieve their future goals (e.g. buying a car, house, retirement) that will set them on a path of financial success sooner.

Conclusion
Saving for your child’s education requires careful consideration and planning. With so many competing financial priorities, accumulating education savings without jeopardizing your own retirement savings may be difficult. Whether you decide to fund the entire cost of your child’s college or only part of it, and whether it includes student debt or not, it pays to start saving early, contributing regularly, and maximizing 529 plans as well as other college savings vehicles where appropriate. Finally, it is important to be aware of some of the rules and implications of these savings options, and taking a lead role in determining which school fits the family budget and needs of the student.
1 “Tuition at Public Colleges Rises 4.8%”, Kim Clark, CNNMoney, October 24, 2012
2 “The College Advantage: Weathering the Economic Storm”, Georgetown University Center on Education and the Workforce, August 2012
3 The College Savings Plan Network September 2012 Report, page 3
5 “Does a 529 plan affect financial aid?” Savingforcollege.com
6 Education Savings Plans, www.studentaid.com
7 UGMA & UTMA Custodial Accounts, www.finaid.org
8 “Average Student Loan Debt Nears $27,000”, money.cnn.com, Oct 18, 2012

United States Department of Treasury Regulation Circular 230 requires that we notify you that this information is not intended to be tax or legal advice. This information cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This information is being used to support the promotion or marketing of the planning strategies discussed herein. BMO Harris Bank N.A. and its affiliates do not provide legal or tax advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

Estate planning requires legal assistance which BMO Harris Bank N.A. and their affiliates do not provide. Please consult with your legal advisor.

Registered trade-mark of Bank of Montreal, used under licence.