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Sterling Investment Advisors Ltd.
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"How do I get ahead of my child's college costs?"

By Timothy E. Flatley

Congratulations! Your second grader is on a fourth-grade reading level! He or she is headed to high school AP classes, the best SAT prep money can buy and, the crowning achievement, to a top university.

I had the privilege of paying $220,000 for my eldest's Yale degree and $150,000 for my second child's College of Charleston degree; recently, I received my third child's Georgetown bill of $27,500. Travel, books and incidentals will hike that bill to $60,000 annually—requiring $100,000 of pretax income. And by the time our second grader arrives at Georgetown, in 2022, the cost for four years will top $355,000.

That is jaw-dropping, but there are various ways to pay. Anyone can receive up to $14,000 annually ($28,000 for a married couple) without gift tax ramifications. (Increasing this amount requires payment of gift tax or use of some of the donor's lifetime gift tax exemption.) However, there is no limit on paying for education. A parent or grandparent may fully fund college and still gift $14,000 beyond the cost of the tuition.

Your child may also receive a scholarship or grant and can certainly help pay tuition through student loans. However, unless they qualify for subsidies, interest rates on loans are high and may not be deducted.

Funds from income are a source but-consume a lot of personal resources. Having multiple children in college magnifies this cash-flow dilemma.

The best option may be a savings plan: the 529 plan, a uniform gift to minor account (UGMA) or a gifting trust. The 529 is popular due to its tax-sheltered growth, which becomes tax free if used for qualified education expenses. Accumulating several hundred thousand dollars in a 529 can potentially save a substantial amount of taxes. Many states also provide an income tax deduction for a resident's contributions to a 529 plan. The donor retains control over the account and may change the beneficiary. Finally, the funds in a 529 account may be withdrawn for noneducation purposes, though this institutes a 10 percent penalty and taxes on the donor's earnings.

The funds in an UGMA account may be used for any purpose that benefits the minor, and control of the account passes to the child at age 18 (21 in some states). There are also some tax opportunities with UGMAs: Parents may gift appreciated stock to their child's UGMA account, and sell the stock at lower tax rates, provided the gain is less than $1,900. Beyond that, the earnings are taxed at the parent's marginal rates.

Alternatively, one can make gifts to a trust for the child. A primary advantage is that access to the assets can be far more restrictive than with an UGMA account, which is automatically accessible when a child turns 18. However, higher tax rates will generally apply.

Returning to our second grader: If a parent or grandparent started from scratch to accumulate the necessary funds for this child's Georgetown tuition by freshman year, assuming a 4 percent annual increase in cost and a 5 percent after-tax return, this donor would have to save approximately $26,000 per year for the next ten years. Using the same rate assumptions, the amount required for the Georgetown savings plan of a child born this year would be $15,000 annually.

The lesson: The sooner you start saving and utilizing efficient planning tools, the more you can mitigate the costs of providing your child a life-changing opportunity.

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