College Savings Plans

This document is designed to provide some insight into the alternatives to be used in saving or investing money for future college expenses

Factors to consider when saving/investing:
•Investment Control
•Investment Flexibility
•Rate of Return versus Risk
•Tax Efficiency
•Affect on Need Based Financial Aid
•Self Completion of the College and Retirement Funding Plan

Choices include:
•Coverdell Education Savings Accounts (only $2,000 a year)
•Qualified Tuition Plans (529 Plans)
•I Bonds & EE Bonds (a number of restrictions)
•Traditional IRA's (not good for college because of liquidity issues)
•Roth IRA's (OK, but limited contribution levels and liquidity)
•Tax Efficient Funds (good but some market risk)
•Annuities (not good because of liquidity issues)
•Real Estate (other than home – has proven to have liquidity problems)
•Life Insurance (cash value may have best benefits – see last page for explanation)

This document will focus on the three choices that allow putting enough away to solve the large future amounts needed. The three are: 529 Plans, Custodial accounts - UTMA & UGMA, which allow a number of investments, and Cash Value Life insurance.

529 Plans

1. **Savings Plan** (every state offers a plan. Each state selects a financial institution to manage a group of mutual funds. You need to select which of these funds you want to use. Choices should be based on your risk tolerance, but during the 2008 market decline no mutual funds or bonds were spared. We don't know what the future holds)
2. **Pre Paid Tuition** (you purchase a certain number of semesters of tuition in the state you reside. In Illinois there are two levels. One includes the University of Illinois and the other includes all other schools. The younger your child when purchased provides the best leverage and return. Tuition is often only about 40% of the total annual cost of college.)

529 Savings Plan Pros:

- Tax-deferred growth
- Tax-free withdrawals if used for college
- Counted as parental assets rather than as students (5% vs. 25%)
- Potential State Tax Deduction
- Can use 5 years worth of gift taxing for single contribution ($130K per couple as of 6/13)
- Can easily change beneficiary to other students

529 Savings Plan Cons:

- Growth is subject to market volatility (high risk – many went underwater in 2008)
- Fees can be higher than normal mutual fund fees
- If not used for college subject to penalties and taxes
- Contributions must be in cash
- Can't be used for collateral or to pay off student loans
- Contributions are limited to annual gifting amounts

529 Pre Paid Tuition Plan Pros:

- Less risk than savings plans
- Better leverage if started when child is young

529 Pre Paid Tuition Plan Cons:

- States have given themselves an out with the fine print
    - Note: Illinois's plan has put in a clause stating that they only have to provide a 2% return over the life of the plan if they can't cover the future tuition costs
- Tuition is only 40% of the cost of normal state schools
- When used at private schools or out of state schools the average credit provided is not as good as for in-state schools

Custodial Accounts (UTMA & UGMA)

Pros:

- Potential for high returns if investment savvy
    - Can purchase individual stocks instead of mutual funds
    - Can put stop loss in place to reduce risk of losses
    - Can use tax-efficient funds
- Contributions can vary in type (non-cash)

Cons:

- Parent's lose control of funds
- Contributions limited to annual gifting amounts
- Growth is subject to market volatility (high risk – many went underwater in 2008)
- Counts against you as student asset for financial aid, or 5 times that of the parent
- No longer as many tax benefits as there was before 1986
- Taxes on growth to be paid each year

Characteristics of a good college savings plan:

- Tax-deferred growth
- Tax-free withdrawals (for anything, not just college)
- Penalty free withdrawals for anything
- No risk, not subject to market volatility
- Guarantees on growth – safety of principal
- Not assessed in the financial aid formula
- Can be used as collateral to keep compounding from being interrupted
- Protection from creditors claims

- Unlimited contribution amounts
- Self completion – cover college expenses should something happen to main contributor
- Complete liquidity, use and control of the funds
- Able to replace funds if desire

A good savings plan for college should include all of the above characteristics. The risk free component was reinforced after 2008 when almost every 529 savings plan, as well as most custodian plans (UTMA) we encountered had less in them than was contributed (under water).

Cash Value Life Insurance

Pros: All of the above characteristics are the pros for cash value life insurance.

Cons: The only con is that you must have the discipline to save an amount every month/year.

A properly funded life insurance policy from a reputable insurance company meets all of these characteristics. It also has, what we believe is a very important feature; it allows you to replace any funds removed for college or anything else. You would borrow from the insurance company using the cash value as collateral, thus allowing you to repay this loan, should you desire, and replace the funds. Once you have found a good place to store/save money, and cash value life insurance has all of the characteristics you want, you should want to replace any withdrawals (at least prior to retirement). Cash value life insurance has none of the 'cons' of the other two major alternatives.

I am partial to properly funded whole life policies from a mutual insurance company. Properly funded means maximum funded up to the government MEC limit, or maximum cash value with minimum death benefit allowed. You want as much of your money going to cash value not to pay for the death benefit. When funded properly the death benefit will get larger as time goes on, so it will be at its highest when you will need it most.

They offer guaranteed safety of growth through dividends and interest accumulation. We prefer mutual companies, where the policy holders are the actual owners of the company, who offer the best long-term value, as you are in theory receiving additional profits as "owners" (all policyholders) versus additional shareholders (not you or other policyholders) getting the profits. They are perfect at providing the 'Private Reserve' banking function (see PRS white paper). Once you have built up your capital (cash value), you can use it as collateral to borrow and repay for major purchases, like college.

As your cash value builds up and just like any other savings account you might posses, you have complete liquidity, use and control of the money via collateralization. By using the cash value as collateral you allow the cash value to continue to compound its growth. Life insurance companies have set up a provision within their policy features that allow the policy owner to take a loan against their cash value. Not *from* their cash value but *against* their cash value. Your initial reaction might be, 'that doesn't sound good during the college years. I don't want to be taking loans.' But taking loans enables you the opportunity to put the money back (you don't have to). Remember, it is growing tax-deferred and continues to compound even though you have taken the loan. It also has all of the other benefits mentioned earlier. In most cases you are still saving for retirement after the kids graduate from college. Cash value life insurance is designed to continue to provide a place to put your money in the most tax favored, safe position.

The last component you need to understand is that with life insurance comes a death benefit. The death benefit is important because it allows the plan to be self-completing. Should the main contributor pass away the death benefit often completely covers the college expenses. At death, any loans outstanding are paid off and any amount left will be paid to your beneficiary – income tax-free!

Tax-free dollars to pay for college while you're living and tax-fee dollars distributed to whomever you choose upon your death. This is why you want to repay any loans while you can so that your cash value can continue to build and be used as future tax-free income and the death benefit for the heirs. Anyone who says that life insurance cost too much, just doesn't understand how to structure it and use it as a strategy.

You might be asking yourself this question about now. Why isn't everyone saving this way? The primary reason is that most people don't know how it works. Financial institutions are more interested in helping you with market choices (529's), because that is how they get paid. Most people need life insurance anyway so purchasing it in this manner is a great way to get the life insurance they want (need) and tax benefits they didn't know existed.

In these whole life policies, all of the money you put into them will be returned to you, **ALWAYS**, either while you are alive, as tax-free income, or it will go to your heir's income tax free. If you are going to get all of your money back sometime in the future, what does that mean? It means that there is really no long term cost, just a temporary cash flow issue. If you were planning on saving money for college, we can even set it up so that the premium payments are automatic, thus providing the necessary discipline.

Obviously the more time you have to save the better this works. This strategy is designed to help you not only save for college but save for your future financial independence at the same time.

We know this concept is contrary to what the financial industry wants you to believe. Saving for college is challenging because you only have a fixed number of years before the bill is due. So no matter how disciplined you are, timing and luck will play a big role. But investment firms who have pushed 529 plans as the answer to soaring college cost often ignore that.

If you are concerned about being able to consistently put a fixed amount away, you might be better to save in a regular savings account. Just don't go dipping into this account and interrupt the compounding.

We would be happy to help you understand how the strategy could work for you. Give us a call and we can set up a meeting to review your situation.

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