KANAWHA CAPITAL MANAGEMENT, LLC

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KANAWHA CURRENTS

Educate Yourself On College Savings Options

This Quarter's Highlights

- 529 Savings Plan
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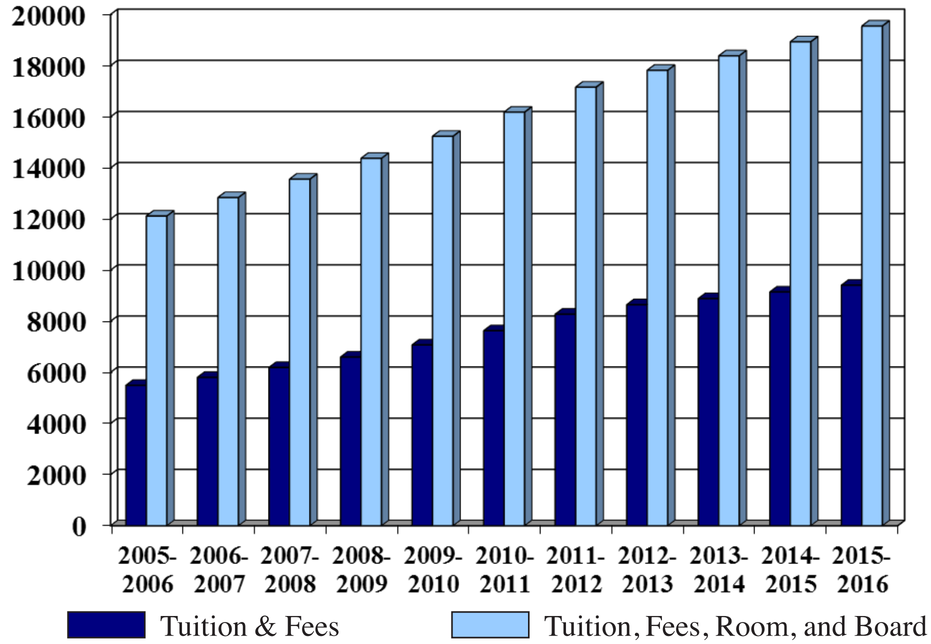
- Case Study

Rising college tuition costs are making it difficult for families to afford higher education. As education expenses continue to climb at rates greater than normal inflation, it's increasingly important for families with children and grandchildren to become aware of the different savings vehicles available in the marketplace to help meet this growing liability.

National Average Annual Cost of In-State Public Four-Year Colleges and Universities



Source: The College Board

There are several different types of accounts investors can use to save for post secondary education costs. The major categories include 529 Savings Plans, 529 Pre-Paid Plans, UGMA/UTMA Custodial Accounts, Coverdells, U.S. Savings Bonds, and standard investment accounts. The account types vary based on tax benefits, contribution limits, qualifying expenses, and income phase-outs, among other factors.

529 Savings Plan

Also known as Qualified Tuition Plans, these plans are authorized by Section 529 of the Internal Revenue Code and are sponsored by states and educational institutions. They are tax-advantaged plans specifically designed to help families save for higher education. The account holder typically chooses between several investment options which may range from individual mutual funds to age-based funds. Importantly, the investment risk is the responsibility of the account holder as there are no performance guarantees.

529 Pre-Paid Plan

Pre-Paid Plans are also authorized under section 529 of the Code but they are very different from 529 Savings Plans. Instead of saving money into a portfolio of mutual funds, Pre-Paid Plans offer account holders the opportunity to lock in today's tuition costs for in-state public colleges. Depending on the plan, payments may be made in a lump sum or in monthly installments.

Generally, these plans are offered only to state residents and are guaranteed by the sponsoring state to cover in-state tuition and mandatory fees only. Most plans do not cover other costs such as room and board.

Pre-Paid Plan benefits may be used towards the cost of out-of-state public universities and private schools, but with limited guarantees. Note there is also a Private College 529 Plan specifically designed to help families save for participating private colleges and universities.

Custodial Account

Custodial accounts offer family members an opportunity to save funds for the benefit of minors. Unlike 529 Plans, withdrawals are not limited to qualified higher education costs. Funds can be used for a variety of purposes as long as they are for the benefit of the minor. Once the beneficiary reaches age of majority (18 or 21 depending on the state) she may spend the money however she chooses. Investment income may be taxed at the beneficiary's tax bracket, but the Kiddie Tax restrictions will apply. The Kiddie Tax applies to children under age 19, or under age 24 if a full time student. Generally, for 2016, the first $1,050 in unearned income will be free of tax, the next $1,050 will be taxed at the child's tax rate, and unearned income over $2,100 will be taxed at the parents' rate. Annual contributions to these accounts are limited to the federal gift tax exclusion amount of $14,000 per donor for 2016.

Coverdell Education Savings Account

Coverdell Education Savings Accounts, like 529 plans, are designed specifically to help families accumulate savings for education expenses. Also similar to 529 plans, contributions are not federally tax deductible but earnings grow tax deferred and can be withdrawn tax-free if used towards qualified education expenses. Unlike 529 plans, funds may be used for private Kindergarten through 12th grade education (elementary and secondary). Contributions are limited to $2,000 per beneficiary per year and there is a Modified Adjusted Gross Income limit of $110,000 (for those filing individually) and $220,000 (for those filing joint tax returns).

Savings Bonds

Series EE and I U.S. Savings Bonds offer a government backed and tax advantaged way to save for post secondary tuition if certain conditions are met. The primary owner must be at least 24 years of age before the bond's issue date, qualified education expenses must be incurred during the year of redemption, and Modified Adjusted Gross Income must be below certain limits. Annual purchases are limited to $10,000 face value per series per person.

Standard Investment Account

Standard accounts that are held in the parent or grandparent's name offer flexibility both in terms of investment choice and in being able to adjust what the funds might be used for in the future. The price for this flexibility is limited tax benefits outside of any education expense deductions and credits that may be available at the time expenses are incurred.

Financial Aid

Any discussion focused on education funding should at least include a cursory overview of financial aid. As the trend in household income has failed to keep pace with college tuition increases, more families today are eligible for some portion of student aid. Even though families with above average incomes and assets are less likely to qualify for need-based aid, it still may be worthwhile for a family to determine if there are any aid packages available, either from the federal or state government, or the schools themselves.

Federal aid programs are typically determined from the Free Application for Federal Student Aid (FAFSA), which calculates a student's expected family contribution. This figure is then compared to the projected cost of attendance to obtain the net financial need. Assets and income in the student's name are generally weighted more heavily than those in the parents' names. But the rules determining ownership can be tricky. Custodial accounts, for example, are deemed to be in the name of the child while 529 Savings Plans and Coverdells are assigned to the parents and, therefore, are treated more kindly under this formula. A 529 Savings Plan held in another family member's name, such as a grandparent, may be the best solution in terms of qualifying for financial aid as the account would not be considered a parent or a child asset on the FAFSA. Most of the financial information listed on the FASFA is now based on the tax year that is two years before the student's admission year. For students applying in the fall of 2016, the base year would be 2014.

	529 Savings Plan	529 Pre-Paid Plan	Custodial Account	Coverdell ESA	Savings Bond
Your Benefit?	Earnings not taxed	Earnings not taxed Guarantee to lock in cost of in-state tuition at public colleges	A portion of investment income may be taxed at child's lower rate	Earnings not taxed	Interest not taxed as long as distribution does not exceed qualified education expenses
Annual Limit?	None (caps on annual federal gift tax exclusions may apply)	Subject to plan pricing	None (caps on annual federal gift tax exclusions may apply)	$2,000 per year	$10,000 face value per series per Social Security Number per year
Which expenses qualify besides tuition and mandatory fees?	Room and board, books, and computers (if required by institution)	None	No restrictions on funds used for the benefit of the minor	Room and board, books, and computers Payments to qualified state tuition programs	Payments to qualified state tuition programs
What education qualifies?	Undergraduate and graduate	Undergraduate	All levels of education for the benefit of the minor	K through 12, undergraduate and graduate	Undergraduate and graduate
Other miscellaneous conditions that apply?	Non-qualified distributions subject to 10% penalty and income taxes on earnings	Limited guarantees if student attends private or out-of-state public school	Kiddie Tax may apply to those who are under age 19 (or under age 24 if a full time student)	Must be distributed at age 30 except if special needs beneficiary	Applies only to series EE bonds issues after 1989 or series I bonds
Income phase-outs?	No	No	No	Yes	Yes

Source: IRS Publication 970 (2015)

Applying for institutional aid directly from a college or university may involve submitting additional information. Students may be asked to complete the FAFSA, a College Scholarship Service (CSS) Profile, and satisfy other requests specific to that institution.

A growing percentage of student aid packages are made up of loans, both subsidized and unsubsidized. Of course, unlike grants and scholarships, these have to be repaid with interest. There are a myriad of federal and private loans available in the marketplace. Recently approved regulations have given student loan borrowers more flexibility in consolidating and repaying federal loans. Borrowers should carefully assess the various options that are available to them and weigh the potential costs and benefits of consolidating existing federal loans under the new rules.

Lastly, families should be aware of potential tax credits and or deductions they may be able to receive to partially offset qualified education expenses. The American Opportunity Credit and the Lifetime Learning Credit can provide taxpayers with a dollar for dollar credit against income taxes owed. Income tax deductions may also be available for student loan interest payments as well as tuition expenses. Consult your tax advisor to determine if you are eligible for any credits or deductions based on your specific outlays towards higher education and your level of income.

Case Study

John and Jane Doe recently had their first child and would like to take advantage of a tax advantaged college savings vehicle. As Virginia residents, they are interested in the Virginia 529 Plan offerings as well other savings vehicles that may make sense for future college funding.

The Virginia College Savings Plan (VCSP) sponsors four different 529 plans; Virginia529 inVEST, Virginia529 prePAID, CollegeAmerica, and CollegeWealth.

The Doe's are familiar with prePAID from friends who began a contract for their newborn child back in 2002. At the time, their friends paid a lump sum amount of $16,372 which locked in the then current cost of tuition and mandatory fees for an in state public college or university for up to four years. In reviewing the most recent prePAID pricing, it will now cost the Doe's $67,800* for the same Four-Year University benefit. The current lump sum pricing compared to the 2002 pricing represents an increase of 414%, or more than 10% per year over 14 years. The rise in prePAID pricing is greater than the increase in the national average rate of public in-state tuition for the same time period. While it appears their friends made a wise financial decision, the Doe's must decide whether or not the current pricing offers sufficient value. They are concerned they might be paying too high of a premium to insure against tuition inflation and investment risk. The Doe's could fund a prePAID plan through one lump sum payment of $67,800* or through a series of monthly payments. If they chose to make monthly payments from now until their child's final year in high school, they would pay approximately $525* per month to lock in prices for their newborn.

Alternatively, the Doe's could estimate how much they need to save and invest on their own by choosing one of the other three state sponsored options. With inVEST and CollegeAmerica, they would have to assume both tuition inflation risk and investment risk. CollegeAmerica and inVEST are similar in that neither guarantees investment returns or locks in the cost of tuition. InVEST is handled directly with the state and their list of pre- approved mutual fund portfolios (age-based or non-evolving). CollegeAmerica, on the other hand, is managed by American Funds and would be accessed through the Doe's financial advisor.

CollegeWealth is unique in that it offers families the ability to save in FDIC protected bank deposit accounts. Funds in these accounts are insured up to the maximum $250,000 per account owner at any one bank. If the Doe's choose College Wealth they would still be exposed to uncertainty around tuition price increases.

Potential Risks of Various Savings Options

prePAID	inVEST	CollegeAmerica	CollegeWealth	Custodial	Savings Bonds
Room, board, books, and other costs not included	Tuition inflation risk	Tuition inflation risk	Tuition inflation risk	Tuition inflation risk	Tuition inflation risk
Limited guarantees if student attends private or out-of-state public school	Stock and bond market investment risk	Stock and bond market investment risk	Current low yield environment on CD's	Stock and bond market investment risk	Current low yield environment on Savings Bonds
				Kiddie Tax	

The Doe's could also decide to pursue one of the options outside of the Virginia sponsored plans. Since they are not sure whether they are going to send their child to public or private elementary and secondary school, both the Custodial and Coverdell options offer some appeal to them. They have agreed, however, that for now they want to set aside money specifically for post secondary education expenses. They feel the state sponsored 529 plans are superior to the Custodial account in their potential tax advantages and to the Coverdell in terms of more friendly contribution amounts. Lastly, they perceive little value in investing money into U.S. Savings Bonds at this time. Note that as Virginia residents, the Doe's will also be eligible for a state tax deduction of up to $4,000 per child per year with unlimited carry forward of unused amounts if they choose one of the Virginia plans.

Trying to decide between the state sponsored plans is far from a perfect science. What option will ultimately prove to be the best will depend on the rate at which tuition and mandatory fees increase and on the investment returns the Doe's could achieve in inVEST, CollegeAmerica, or CollegeWealth. If future rates of tuition inflation are lower and investment returns are higher than predicted, then the Does may be better off choosing inVEST or CollegeAmerica. If the opposite scenario unfolds, and tuition prices continue their pace of ascent and investment returns are below average, then the prePAID plan would likely be the best option for the Doe's. While these uncertainties make it difficult to determine the most suitable plan, families must educate themselves on the potential benefits and risks of each plan in order to make an informed decision.

**Dollar amounts are based on the most recent enrollment period from December 1, 2015 through March 31, 2016. Future enrollment periods will have higher costs.*