Ruminations on College Funding

While considering college funding, I tend to have clients fund their goals in this order:

1. Tax-advantaged retirement plans in full. There are lots of ways to go to college but not that many ways to be retired. Many people shouldn't even be doing *any* college planning – they can't afford it. In addition, contributions to Roth accounts could be withdrawn for education (or any other reason).
2. Extra principle payments on the mortgage (home equity frequently doesn't count toward financial aid eligibility). A HELOC (Home Equity Line Of Credit) could then be tapped for education expenses.
3. Coverdell Savings Accounts.
4. 529s.
5. Taxable accounts.

Note that while this is "typical," every client is different, and *many* cases will have different ordering depending on the specific tax situation, asset allocation, goals, and projected future cash flows. However, for the "normal" client, I would fully fund each option sequentially before the next.

Prioritizing Coverdell ahead of the 529 in funding may seem peculiar because most folks seem to favor the 529. They are not mutually exclusive, we are merely prioritizing which to fund *first*. It is a close call, but consider the following (in no particular order):

1. Many people believe they can't do a Coverdell because of the earnings limit. However, you can gift money to the child who *can* fund the Coverdell; so the earnings limit shouldn't be a real issue in most cases. This does have the disadvantage of the child being able to access the funds – possibly *not* for education. It also would be considered the child's asset rather than the parent's for financial aid calculations which is not as favorable. Advantage: 529.
2. Previously the 529 had better treatment than the Coverdell when calculating financial aid eligibility, but now *both* are considered the asset of the parent in most cases. Advantage: tie.
3. States may change the state tax treatment of 529 withdrawals in the future (particularly those from out of state). Coverdell accounts are federal and not subject to the same risks. Of course, some states have state tax deductions for the in-state 529s that must be considered also. Conclusion: depends on magnitude of your state's current tax advantages if you are doing an in-state plan, for out-of-state plans. Advantage: Coverdell.
4. The Coverdell obviously has more flexibility of investments. This is particularly important because you can purchase index funds or ETFs and improve returns by 50 basis points or more over the options typically present in the 529 (if you believe as I do that the market is semi-strong form efficient). The younger the child, the more important this factor is. Suppose there is a state tax deduction (6% state rate) for contributing to the 529, but the investment options are likely to underperform by 50 basis points per year. For a 16-year-old the state tax deduction will clearly trump the short period of lower performance. For a 4-year-old the reverse is true. Advantage: Coverdell (generally).
5. The Coverdell must be used by age 30 (or transferred to a younger family member) while a 529 has no such requirement. Most folks are done with college well before age 30, so this shouldn't be a significant issue. Minor Advantage: 529.
6. The Coverdell can be used for elementary or secondary education, the 529 may not. Minor Advantage: Coverdell.

Overall Conclusion – Coverdell by a nose…

Notes:

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