

A Crash Course in College Savings Plans

The right strategy can ease your tuition fears.

When you're planning for your child's education, it pays to understand how to invest your hard-earned dollars. Today there are many different types of plans with benefits for qualified education expenses.

Here are the pros and cons of the most popular college funding vehicles currently available:

1. Section 529 Savings Plans
2. Coverdell Education Savings Accounts
3. UTMA/UGMA (Uniform Transfer to Minors Act/Uniform Gifts to Minors Act)
4. Saving in the Parents' Names
5. Section 529 Prepaid Tuition Programs
6. 2503(c) Minor's Trust
7. IRA or 401(k) Withdrawal
8. Savings Bonds

Section 529 Savings Plans

529 Savings Plans have been bashed in the press in the past year over everything from high expenses to trading abuses and outright fraud. Yes, there have been problems. But let's not throw out the baby with the bath water.

529 Savings Plans still offer good opportunities to save for college through state tax breaks, matching state contributions (in Rhode Island, Michigan, Maine, Minnesota, and Louisiana), tax-free use of the money for qualified education expenses and expanded annual gifting thresholds.

Using a 529 plan, anyone can contribute money on behalf of a beneficiary. Contributions are invested according to options directed by the plan. One of the downsides of these plans is that you can only change your investment selection once per calendar year.

Pros:

- Money can be used for any college in the U.S.
- Possible state tax breaks for contributions. Matches in some states (see above).
- Tax-free distributions for qualified expenses (tuition, fees, books, supplies, required equipment, room and board).
- Can claim HOPE and Lifetime Learning Credits as long as the payout from the 529 plan isn't used for the same expenses for which credit is taken.
- Can gift up to \$55,000 a year per child without triggering gift tax (gift assumed to be \$11,000 ratably over five years). Effectively removes this money from your taxable estate (if you die within five years, a portion may be included in your taxable estate). If you gift-split with your spouse, you can get \$110,000 out of your estate without triggering gift tax.
- Can contribute to both an Education IRA and a 529 plan, but watch out for gift tax consequences if you contribute more than \$11,000 per person in the same tax year.
- Can contribute more than \$55,000 a year and use increased unified credit to offset gift tax on \$1,000,000. Check with each state plan to verify the maximum contribution.
- Donor retains control of account. If beneficiary doesn't go to college, donor can get his/her money back although he or she would owe tax on the earnings and a 10% penalty.
- No earnings restrictions.
- No limited enrollment period.
- If parent is donor, financial aid will only count 5.6% in the family contribution formula.

Cons:

- Must use investment options chosen by the plan.
- You could lose money in more-aggressive investment options.
- You can only change your investment choices once per calendar year.
- Expenses of the plan may be higher than what you'd pay if you invested the money yourself.
- A nonqualified withdrawal (used for purposes other than specified education expenses) will be taxed on earnings and will incur a 10% penalty. Exceptions to the penalty include death or disability of the beneficiary or if the beneficiary receives a scholarship. Nonqualified withdrawals can also negatively affect financial aid.

- Plans may limit contribution amounts.
- Since donor owns the account, it may be tapped by Medicaid if the donor should need nursing home care and not have other funds available.
- Not all states have protections against donor's creditors.
- If a grandparent is the donor, earnings withdrawn may count as income in financial aid formulas.
- May need to file a gift-tax return if contribution per child is over the annual exclusion of \$11,000 per person. So, for example, if you contributed \$25,000 as a single parent, you'd need to file a gift tax return and show \$5,000 is gifted in each of five years. No tax would be due, but you'd have the expense (and hassle) of filing a gift-tax return.

Choosing among state 529 savings plans:

If you think a 529 savings plan could be part of your college funding solution, you should start by looking at the plans in your own state or the state in which the beneficiary lives. Try Morningstar's 529 database as a resource. Other good resources include "The Best Way to Save for College" by Joseph F. Hurley and www.savingforcollege.com.

Coverdell Education Savings Account

Formerly known as the "education IRA," this type of college savings vehicle has been greatly expanded with the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). Contributions have been increased to \$2,000 per person per year. Accounts can be set up with most brokers or mutual fund companies.

Pros:

- Great flexibility of investment choice.
- Expenses may be lower than in some state 529 plans.
- Money can be used for primary and secondary education expenses.
- Tax-free withdrawals for qualified education expenses (tuition, fees, tutoring, books, supplies, related equipment, room and board, uniforms, transportation, extended day programs, computers, Internet access).
- Can make contributions up until April 15 of the following year.
- Anyone can contribute if he or she meets the earnings requirements (see below).
- Can contribute to both an education IRA and a 529 plan, but watch out for gift-tax consequences if you contribute more than \$11,000 per person in the same tax year.
- Can claim HOPE and Lifetime Learning Credits as long as the payout from the education IRA isn't used for the same expenses for which credit is taken.

- If you don't meet the earnings requirements (see below), you can gift \$2,000 to the beneficiary and let him or her set up his or her own account. So, for example, if a grandparent didn't meet the earnings requirement, he could gift to the adult child to use for a grandchild's account. (Giving to the adult child is better than giving to the grandchild directly because of financial aid rules.)
- New rules allow that Coverdells are to be treated the same as 529 Savings Plans for financial aid purposes (5.6% counted as a parent's asset).

Cons:

- Total contributions may not exceed \$2,000 a year per beneficiary.
- No matter how many people contribute, total contributions per child can't exceed \$2,000.
- Earnings restrictions: If you earn \$95,000 to \$110,000 (single) or \$190,000 to \$220,000 (married filing jointly), contributions will be limited; if you earn more than \$110,000 (single) or \$220,000 (married filing jointly), contributions are not allowed.
- Beneficiaries must be under age 18 when contributions are made (except special-needs beneficiaries).
- Money must be used by age 30 or earnings are taxed as ordinary income plus a 10% penalty (except special-needs beneficiaries). To avoid this taxation, accounts can be rolled over into another family member's Coverdell accounts.
- If the beneficiary doesn't go to college or use the money for primary or secondary school, the donor can't get the money back.
- No state tax deduction for contributions.
- No guarantee of positive investment returns; account can lose money.

UTMA/UGMA (Uniform Transfer to Minors Act/Uniform Gifts to Minors Act)

This is a custodial account set up on behalf of a minor.

Pros:

- No earnings restrictions, although amounts in excess of \$11,000 per person (\$22,000 if gift-splitting with spouse) will be subject to the gift tax. (May be able to use unified credit to offset excess gift tax.)
- Can invest in wide variety of investment vehicles.
- Easy to open.
- Less expensive than setting up a trust.
- Psychological benefit of earmarking funds for college.
- Lower tax on dividends and long-term capital gains for most people.

Cons:

- Child takes control of the money at the age of majority (18 or 21).
- Income taxed to the child each year. When the child is under age 14, the first \$800 is not taxed due to standard deduction. The next \$800 is taxed at the child's rate (starting at 10%) and anything above \$1,600 will be taxed at the parents' rate. At age 14 and older, income is taxed at the child's rate (the first \$800 is not subject to tax due to standard deduction). The parent is responsible for making sure an income tax return is filed on the child's behalf.
- If you serve as custodian of the account and you die, the UTMA/UGMA will become part of your taxable estate.
- Because the child owns of account, more of this money will be counted toward the family contribution when determining financial aid eligibility.
- Gifts made to UTMA/UGMA accounts are irrevocable.
- Accounts must be terminated once the child reaches age of majority.
- No guarantee of positive investment returns; account can lose money.

Saving in the Parents' Names

As a parent, if you want to maintain control of the assets, have maximum investment flexibility, and keep assets out of the child's ownership (for financial aid purposes), then you may want to consider saving a portion (or all) of your college funding money in your own name. If your child doesn't go to college, you have the flexibility to use the money for any purpose. You also avoid the expense of setting up a trust. The big disadvantage is that you are taxed on the earnings of the investments.

Section 529 Prepaid Tuition Programs

Typically, these are state-sponsored programs that allow anyone to purchase tuition credits or certificates on behalf of a beneficiary. In a state-sponsored program, your child needs to go to college in that state to get the maximum benefit of this program.

In the past year, independent prepaid tuition plans have emerged. These plans let your child attend college at any participating private college in the U.S. To learn more, go to www.independent529plan.com.

Pros:

- No income restrictions on donor.
- Benefits are federally tax-exempt if used for qualified expenses.
- If the child attends a school within the plan, costs are covered by credits or certificates purchased.

- By buying prepaid tuition credits, you lock in future tuition costs at today's rates.
- There may be state tax breaks when you contribute.
- No investment risk, unless the state mismanages the funds.

Cons:

- May have a limited enrollment period.
- May significantly reduce opportunities for financial aid.
- Only certain schools participate.
- If child attends out-of-plan school, some costs may not be covered.

2503(c) Minor's Trust

This is a separate entity set up to manage money on behalf of a minor.

Pros:

- Trustee has ability to spend money on behalf of the minor until he or she reaches age 21 (and in some cases, beyond age 21).
- Can contribute an unlimited amount, but amounts in excess of \$11,000 per year per beneficiary (\$22,000 if gift-splitting) may be subject to gift tax. (May be able to use unified credit to offset gift tax.)
- Trustee can invest in a wide variety of investment vehicles.

Cons:

- May be expensive to set up.
- Child gains control at age 21.
- Income taxed at trust rates (higher than individual rates).
- Gift to trust is irrevocable.
- May decrease chances of receiving financial aid.
- No guarantee of positive investment returns.

IRA or 401(k) Withdrawal

Pros:

- No 10% penalty on IRA withdrawals if used to pay qualified higher-education expenses (college tuition, books, fees, supplies and equipment) of the taxpayer, spouse, child, or grandchild.
- You can take a loan from a 401(k) (or similar type of plan) and pay it back over time.

Cons:

- If it's a traditional IRA, ordinary income tax will be due on distributions.
- If the Roth IRA owner hasn't been invested for five years, ordinary income tax will be due on only the earnings portion of the distribution.
- Withdrawals may be counted as income in financial aid formulas.
- Dollars used to pay back a 401(k) loan are, in part, taxed twice. You use aftertax dollars to repay the interest on the loan and then pay tax again when you take retirement plan distributions in the future (withdrawals taxed as ordinary income).
- You may be hurting your own retirement funding.

Savings Bonds

Pros:

- Safe. Backed by the U.S. government.
- EE-bonds purchased after 1989 and all I-bonds allow tax-exempt distributions if used for qualified education expenses (tuition and fees) and if income limits are met (see below).
- Can buy \$30,000 each of I-bonds and EE-bonds a year.
- Interest exempt from state and local taxes.
- No penalty if not used for college.

Cons:

- You forfeit three months of interest if you redeem before five years.
- You have to be at least 24 years old to buy the bond.
- If your income is more than \$76,200 (single) or \$121,850 (married filing jointly), you can't exempt the interest even if the proceeds are used for qualified education expenses.
- Only tuition and fees are qualified education expenses.
- Only the bondholder, his/her spouse, or a dependent get the interest exclusion. If the grandparent holds the bond, he/she can't claim any interest exclusion unless the grandchild is dependent.
- The interest exclusion may be reduced by other education tax breaks (HOPE Scholarship, Lifetime Learning Credit, scholarships, Education IRA withdrawals, Section 529 plan withdrawals) when used in the same tax year.

Education Tax Incentives

Not only do you have the above college savings vehicles available to you, you may also get additional tax breaks from Uncle Sam.

HOPE Scholarship:

- Taxpayers can deduct 100% of the first \$1,000 of qualified education expenses plus 50% of the amount paid over \$1,000.
- Maximum credit per student per year is \$1,500.
- Can use credit for only two years.
- Can't be used if student has already completed two years of college.
- Can't apply same expenses to both HOPE Scholarship and Lifetime Learning Credit.
- Can't claim if modified adjusted gross income in 2004 is more than \$53,000 (single) or \$107,000 (married filing jointly).

Lifetime Learning Credit:

- Taxpayers get a credit on their income tax return of 20% of up to \$10,000 for qualified education expenses actually paid.
- No limit to number of years the credit can be claimed.
- Can't apply same expenses to both HOPE Scholarship and Lifetime Learning Credit.
- Can't claim if modified adjusted gross income in 2004 is more than \$53,000 (single) or \$107,000 (married filing jointly).

Tuition Tax Deduction:

- Taxpayers who fall within certain income limits may be able to deduct money spent on tuition and related education expenses.
- If modified adjusted gross income in 2005 is less than \$65,000 (single) or \$130,000 (married filing jointly), up to \$4,000 may be deducted. A partial credit is allowed if adjusted gross income is less than \$80,000 (single) or \$160,000 (married filing jointly).
- Can't use the deduction if claiming HOPE or Lifetime Learning Credit in the same year.
- Can't use if expenses were paid by tax-free withdrawals from Education IRA or U.S. Savings Bonds.

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