



Tax advantages can stretch your education dollars.

Higher education costs continue their relentless upward spiral. For the 2006-2007 academic year, the average cost at a four-year private college topped out at over \$30,000. Many families are turning to an array of tax-advantaged savings accounts to help them meet the high cost of higher education. Contributions to such plans are not deductible, but taxes on growth and earnings in them are deferred and may be avoided altogether when the funds are used for qualified education expenses.

Tax-preferred choices

Because families have differing needs, resources and objectives, Congress has created several tax-preferred paths for education funding.

Coverdell Education Savings Account (CESA). Up to \$2,000 may be set aside each year for a student's future education expenses. That annual limit applies on a per child basis—if parents and grandparents all want to contribute something to CESAs, they will have to coordinate their gifts so as not to overstep the dollar limit. Also, higher-income taxpayers are not permitted to make contributions—this limitation applies to the donor, not to the child. To make a maximum \$2,000 contribution, the donor's income can't exceed \$110,000 for a single taxpayer (\$220,000 for marrieds filing jointly). CESA contributions are not permitted once the child reaches age 18.

Distributions that are used to pay qualified education expenses are excluded fully from additional income tax. Money not so used is potentially taxable, and a 10% penalty tax will apply. Funds must be distributed by the time that the beneficiary reaches age 30. But a rollover to a CESA for another family

member, such as a younger brother or sister, is permitted.

A donation to a CESA is a completed gift, which will be protected from the gift tax by the annual gift tax exclusion (\$12,000 in 2007). The donor controls investment of the CESA funds. The rules and their practical effects are essentially the same as for IRAs.

529 plan. These plans generally are sponsored by the states, and they have the great advantage of no income limits on the donors and very high annual contribution limits (varying from plan to plan). Earnings accumulate tax deferred, and distributions used for qualified education expenses are tax free, just as with CESAs.

One final feature of 529 plans is considered a positive by some, but a drawback by others. Investment management is controlled by the plan, and the donor's choices are limited. The donor may choose from funds with a range of risk and reward characteristics and, typically, may alter that choice just once each year. Some plans offer funds that automatically shift to more conservative investments as the child approaches college age. With 529 plans, as with investing in mutual funds, the donor will want to make a thorough investigation before committing any funds.

Independent 529 Plan. An alternative to saving for college is prepaying those expenses years in advance. The defect in that idea is that one typically doesn't know what school the child is likely to choose. However, that problem has been resolved for those schools that joined together to create the Independent 529 Plan in 2004. Funds that are contributed to this plan are a tuition prepayment for any of the participating schools. The percentage of prepayment will not be

the same for each school, but will be geared to that school's current tuition rates.

For example, let's say that \$12,000 is contributed this year for a child who will enter college in ten years. That contribution will pay 100% of the first-year tuition at a school that this year charges \$12,000, or it will pay 50% if the school charges \$24,000 now. The actual amount of the future tuition charges won't matter—the risk of rising education costs is shifted from the families to the schools with this approach.

Investment risks are shifted as well. Whether the fund does well or poorly, if the student goes to one of the participating schools, the tuition is proportionately prepaid. If the student does not go to college, or chooses a nonparticipating school, contributions will be refunded, subject to a maximum rate of return of 2% (up or down) compounded annually. Taxable alternatives: UGMA or UTMA

Before the tax-preferred college savings vehicles became available, parents and grandparents transferred money to custodial accounts for prospective students under either the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act (depending upon the law in one's state of residence). Such accounts offer no income tax advantages and are subject to the "kiddie tax" for children under age 18. Another disadvantage is that the money must be distributed to the child, typically upon reaching age 21.

On the other hand, usage of funds in these accounts is not limited to education expenses. Thus, custodial accounts may provide a useful supplemental financial resource.

Permanent trust. Wealthier families may consider establishing a trust to provide a permanent financial foundation for children. Such a resource can be used for education expenses as well as the eventual establishment of a business

or professional practice. Permanent trusts have a variety of estate and gift tax implications to be considered as well.

Which is best for you?

There are, of course, pros and cons to each of the alternatives available to you. For instance, for more complete planning, one also needs to take into account other tax benefits, such as the Hope and Lifetime Learning Credits.

It's not much of an exaggeration, then, to say that one almost needs an advanced degree to sort out and manage the complexities of education funding these days!

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