Tax Advantaged Education Savings Options

Overview

Saving for college education can be an intimidating undertaking for many parents who may be inexperienced with tax laws, and unsure how to balance their own financial goals, such as saving for retirement and the financial needs of their children. There are many options available to finance a child’s education, and which one or more options to choose requires consideration of many important factors.

One consideration is whether the parents wish for the child to pay for any portion of his/her own education such as by obtaining student loans. Doing so would allow a child to become a stakeholder in his/her education. Note: Congress may change the treatment of assets for financial aid eligibility and thus any comments below are subject to change, and a determination of financial aid eligibility should be corroborated with a professional with knowledge in this area.

A second consideration is what expenses are eligible with respect to each option. Some education savings vehicles can be used only for college tuition, while others can be used for books, fees, room and board, equipment, and other education-related expenses. Still other plans allow funds to be used for primary or secondary education in addition to college and university education.

Another consideration is the tax implications of saving and paying for a child’s education. This consideration includes review of applicable federal and state income, gift, estate, and generation skipping taxes. Note: There may be tax deductions and credits at both the federal and state levels that are beyond the scope of this paper.

Also worthy of consideration, especially for parents with only one child, is what happens to the funds allocated to an education plan if that child does not attend college.

Another very important consideration is the parents’ other financial goals, including saving for retirement and paying for life insurance protection, and the potential of dual use of allocated funds.

Perhaps the most substantial consideration of all is timing. If the child is very young and college is far away, then the parents have time to systematically accumulate and invest money, which allows for growth of the assets. If college is right around the corner, then other options should be considered, such as borrowing against existing assets.

Education Savings Strategies

Qualified Transfers Resulting in No Gift or Generation Skipping Transfer Tax

A straightforward approach to education funding is direct payments of certain educational expenses to a qualified educational institution. An exclusion exists within the Internal Revenue Code for such transfers, whereby such payments are not considered to be taxable gifts. Parents, grandparents, uncles, aunts, other family members and friends can pay for the child's education. Qualified educational institutions include primary and secondary schools, colleges, and universities. Qualified expenses include tuition only and not room and board, books, supplies, and other similar expenses, which do not constitute direct tuition costs. Tuition can be prepaid, and thus a larger gift can be made in one year to prefund a child's future tuition costs.

Uniform Transfers to Minors Act (UTMA) / Uniform Gift to Minors Act (UGMA)

An UTMA/UGMA (herein UTMA) is a custodial account established on behalf of a minor. Because a minor cannot legally own assets, an UTMA is a method whereby an adult custodian may use assets from an investment account on behalf of and for the benefit of the minor. Transfers to an UTMA qualify for the annual gift tax exclusion. Funding methods include cash, securities, real estate (for UGMA accounts only), etc. The UTMA has no limits on usage for education or otherwise. UTMA accounts can benefit a single person and cannot be redirected. Legal title transfers to the minor upon attaining a specific age, typically age 21 (although some states allow postponement to a later age). For estate tax planning purposes, the custodian should not be the person making the transfer, nor the minor's parents; otherwise, the assets will remain part of the transferor's estate. Contributed funds are taxed to the beneficiary, however, if the beneficiary is under age 18, investment income in excess of certain thresholds could be taxed at his/her parents' marginal tax rate.

UTMA accounts are reported as an asset of the child on his/her Free Application for Federal Student Aid (FAFSA) and will reduce his/her eligibility for financial aid.

Section 2503(c) Minor's Trust

A Section 2503(c) Trust is a trust designed to hold gifts in trust for a minor. Gifts to a 2503(c) trust qualify for the annual gift tax exclusion, and the funds can be used for the benefit of a minor. When the beneficiary attains age 21, the assets are not required to be transferred to the beneficiary (unlike a UTMA), and instead the funds can be left in trust, subject to the beneficiary's right to withdraw those funds. A variation of a 2503(c) trust is a "Window Trust," whereby the trust document establishing the 2503(c) trust will restrict the withdraw right to 30, 60 or 90 days after the child turns 21. If the child does not exercise his/her right to the trust funds during this window, the money can remain in the trust until a date specified in the trust document. Any income produced by a 2503(c) trust is taxed to the trust at trust tax rates. If the donor of assets to the trust also acts as a trustee, the trust will be included in the donor's gross estate for estate tax purposes. Unlike an UTMA account, 2503(c) trusts require an attorney to draft a trust document. Also, 2503(c) trusts are reported as an asset of the child on FAFSA and will affect eligibility for financial aid.

Section 529 Plan

A section 529 plan is sponsored by a state or a single education institution. There are two types of 529 plans: prepaid plans and savings plans. A **529 prepaid plan** guarantees an increase in value at the same rate as college tuition, and therefore locks in tuition at current rates. This inflation protection increase is free of income tax. Prepaid tuition plans are often guaranteed by the full faith and credit of the state. For state sponsored plans, if the student attends an in-state public college, the plan would pay the tuition and required fees. If the student attends a private college or out-of-state college, the plan will pay the average of the in-state public college tuition and the rest will be paid for by the family or child. State operated prepaid plan funds may be applied only to tuition and fees. Prepaid tuition plans typically have contribution limits based upon the current cost of four years of in-state public colleges and typically range from $50,000 - $100,000. If the child decides not to attend college, contributions can be refunded or transferred to another family member. Prepaid plans hedge against economic downturns.

A **529 savings plan** is an investment oriented plan, whereby contributions are invested through certain state endorsed investments. Section 529 savings plans have market risk; the value of the account will rise and fall based upon the performance of the particular investment option chosen. Account earnings are tax deferred, and withdrawals are income-tax free if used to pay for certain qualified educational expenses including tuition, books, and room and board for those attending at least half time. Each state enforces a specific total contribution limit. These limits are typically between $300,000 and $500,000 per beneficiary. The account is controlled by the account owner (parent or grandparent, etc.) and donors can choose the plan of any state. If the beneficiary chooses not to attend college, the owner may transfer the plan to another family member. If the owner cancels the account and receives a refund, he/she will pay federal income taxes on the earnings, if any, plus a 10% penalty. An exception to the 10% penalty are cases involving the death of the student, disability, and receipt of scholarship. There also may be additional state and local income taxes and penalties. Generally this type of plan is favorable when the beneficiary is at a young age, such that there is sufficient time to bear the inherent market risk and give account assets time to grow.

Some states with an income tax may offer tax incentives for their residents to contribute to state-sponsored 529 plans (both prepaid and savings plans). In such states it is encouraged that parents save an amount each year equal to at least the state income tax deduction allowed for contributions.

A 529 plan that is owned by the child's parent or by the child him/herself is reported on the FAFSA and will affect the child's eligibility for student loans; distributions from a 529 plan owned by a grandparent or other relative will also affect eligibility for student loans.

Health and Education Exclusion Trust

A Health and Education Exclusion Trust (HEET) is an irrevocable dynasty trust established either during a grantor's lifetime or upon his/her death. HEETs are typically set up by grandparents to provide payments for the education and medical care of grandchildren. HEETs are designed to avoid the generation skipping tax (GST) by making direct payments ("qualified transfers") to "qualified" educational and medical institutions and by including a charitable beneficiary. Thus, the grantor(s) must be charitably inclined; however, the grantor(s) will not receive a charitable deduction unless the trust is structured as a grantor trust. A HEET will also provide significant creditor protection for the HEET's beneficiaries. A HEET is particularly appropriate for grandparents seeking to make transfers to grandchildren in excess of the GST exemption.

Qualified payments by the trustee of the trust includes payments for tuition to primary and secondary schools, colleges, and universities. Costs of the student's books, supplies, and room and board are not included. Health and medical benefits include payments made directly to medical care providers for "services such as expenses for diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body."

A HEET created during lifetime can significantly reduce the ultimate estate tax liability, because appreciation of, and income generated by, assets contributed to the HEET are removed from the estate.

HEET trusts will likely count as an asset of the beneficiary on FAFSA and affect the student's eligibility for financial aid.

The Roth IRA

A Roth IRA can be used for both college expenses and retirement income. Deposits into a Roth IRA receive no income tax deduction; however, these assets grow tax deferred. Withdrawals from Roth IRAs are exempt from withdrawal penalties if the funds are used specifically for qualified educational expenses, which include tuition, fees, books, room and board, and other education related expenses. However, only the contribution portions of the Roth IRA balance can be withdrawn both penalty- and tax-free, as any earnings in the account will be taxable for those persons under age 59½, as well as those over age 59½ who have not held the Roth IRA for at least 5 years. Roth IRAs are not reported on a FAFSA.

Cash Value Life Insurance

Cash value life insurance is used for insurance protection, but also can be used to supplement retirement income, and as a source for financing a child's education. With a whole life contract, every premium dollar paid in excess of the cost of insurance and policy administration costs increases the policy's cash value, essentially combining a death benefit with a savings element. The increase in the investment element (cash values) occurs on a tax-deferred basis.

When it is time for a child to attend college, the owner of the policy can borrow against the cash value of the policy. Amounts borrowed from the policy are not a taxable distribution, so long as the policy is not a modified endowment contract (MEC). Moreover, the interest rate on the policy loan usually is lower than that of a commercially obtained loan secured by other less liquid property. Flexible premium universal life and variable universal life policies typically include the option to take partial withdrawals of cash value without triggering loan interest charges. Note: The cash value in a life insurance policy is accessed through withdrawals and policy loans, which accrue interest at the current rate. Loans and withdrawals will decrease the cash surrender value and death benefit. Cash value life insurance is not reported on a FAFSA.

Coverdell Education Savings Account

A Coverdell Education Savings Account, commonly referred to as an ESA, is a trust or custodial account designed to provide tax-free appreciation of assets and tax-free withdrawals when the funds are used for qualified education expenses. ESAs, however, are not merely for college education; savings may be used to pay for primary and secondary education expenses. ESAs typically offer greater investment options than 529 plans. A drawback with these types of accounts is the contribution limits which are restricted to $2,000 a year, and are phased out for parents with modified adjusted income starting at $190,000 - $220,000 (for joint filers) and $95,000 - $110,000 (for single filers).

An ESA that is owned by the child's parent or by the child him/herself is reported on the FAFSA and will affect the child's eligibility for student loans; distributions from an ESA owned by a grandparent or other relative also will affect eligibility for student loans.

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