

## Tax Strategies for Financing Education

Traditionally, formal long-term tax planning has been directed toward creating an estate and providing assets for retirement income with a minimum of taxable consequences. With escalating educational costs and a variety of options available for financing the education of children, educational tax planning has become increasingly important.

### Available Tax Credits and Deductions

**Tax Credits.** Congress created two tax credits for taxpayers with education costs – the **Hope Tax Credit** and the **Lifetime Learning Credit**. However, these credits are not available to higher income taxpayers. They are phased-out between \$43,000 and \$53,000 of modified adjusted gross income (MAGI) for single taxpayers and between \$87,000 and \$107,000 of MAGI for married couples filing jointly. Both education credits are nonrefundable and cannot exceed a taxpayer's tax liability. An eligible student may be the taxpayer, the taxpayer's spouse or a dependent for whom the taxpayer claims a dependency exemption. Qualified educational expenses are out-of-pocket costs for tuition and fees required for enrollment or attendance. Books, supplies and equipment do not qualify unless they are a condition of enrollment. Room and Board, insurance, and similar personal and living expenses also do not qualify.

The **Hope Tax Credit** provides for a tax deduction of 100% of the first \$1,000 paid for tuition and qualified educational expenses during the tax year and 50% of the next \$1,000. If there is more than one student in the family the maximum of \$1,500 can be taken for each student. The student must carry at least half the normal full-time workload as required by the institution. The Hope tax credit only applies to the first two years of the student's post-secondary education at an eligible educational institution.

The **Lifetime Learning Credit** is \$2,000 per year per taxpayer (20% of up to \$10,000 of qualified educational expenses). The credit can be claimed even if the student is enrolled on less than a haltime basis. Also, eligible courses include those that are part of obtaining a degree to acquire or improve job skills. The credit is not limited to students in the first two years of post-secondary education.

**Tuition and Fees Deduction.** As an alternative to the above tax credits, a deduction of up to \$4,000 is available for qualified tuition and required enrollment fees. The deduction is above the line, which means that it can be taken whether or not the taxpayer itemizes deductions. A benefit of the tuition and fees deduction is that it has a higher income limitation than the credits. A partial deduction is allowed for MAGI of up to \$80,000 for single taxpayers and \$160,000 for married couples filing jointly. However, the deduction expires after 2005, and will not be available thereafter unless Congress extends the provision.

A number of tax planning opportunities exist for those incurring tuition costs. The deduction and credits can all be claimed if there are different qualified students for each

category. Taxpayers who are eligible for either of the credits or the deduction should consider which gives them the highest overall tax savings. Additionally, a planning opportunity exists for a parent to forego the dependency deduction for a student in order for that student to claim one of the credits, sometimes lowering the family's overall tax burden.

**Deducting Interest on Qualified Education Loans.** Interest due and paid on qualified education loans for "qualified higher education expenses" can also be deducted "above the line." The maximum amount of interest a taxpayer is allowed to deduct is \$2,500, and this amount is reduced ratably if AGI is above \$105,000 for married joint filers and \$50,000 for single and head of household filers.

Qualified Higher Education Expenses for purposes of deducting interest on student loans are the student's cost of attending the educational institution, including tuition, fees, room and board, books, equipment and related expenses.

### **Financing Higher Education**

**Gift Tax Exclusion for Tuition Payments.** Taxpayers incur no gift tax consequences when the total gifts made to a recipient during a year are no more than the annual gift tax exclusion. Transfers to a student or another individual for purposes of paying educational costs are treated as gifts subject to the annual gift tax exclusion. However, tuition payments made directly to an educational institution on a recipient's behalf are an exclusion under the gift tax rules and can be made in addition to amounts gifted under the annual exclusion. This allows a good planning opportunity for grandparents (or any other family member), removing assets from their taxable estates for a grandchild's education without incurring any transfer tax consequences.

**Using Traditional or Roth IRA Withdrawals.** A taxpayer may make withdrawals from a traditional or Roth IRA to pay the qualified higher education expenses for the taxpayer; spouse; or the children, stepchildren, or grandchildren of the taxpayer or taxpayer's spouse at an eligible educational institution without incurring the 10% early withdrawal penalty. However, if the withdrawal is from a traditional IRA the taxpayer will owe federal income tax on the amount withdrawn. Taxpayers may make tax-free withdrawals from the contributions to a Roth IRA as an additional source of college education funds. Once a taxpayer turns age 59 ½, earnings from a Roth IRA can also be withdrawn tax-free, if the account has been open at least five years.

**Shifting Assets and Income to Maximize College Funds.** Funds can be transferred to children to be used to pay their education costs. Property can be gifted to a child under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), as well as to trusts directed to pay the educational costs. Additionally, a child can be employed in a family business, using the income they earn to pay for education costs.

**UGMA** or **UTMA** funds can be used to pay a child's college education expenses. The custodian, who can be a parent, holds the property for the child's benefit. The custodian must distribute the assets to the minor when they reach the age of majority (18-21 depending upon state law). This is a major disadvantage of these accounts, as the assets pass directly to the child's control at the age of majority and can thus be used by the child for any purpose, not limited to college financing. Also, they are considered the child's assets for purposes of determining college financial aid. A child's assets reduce the qualification for financial aid much more than assets considered owned by a parent.

For income tax purposes, income earned on UGMA/UTMA accounts is taxable to the child. If the child is under 14 years of age, income that exceeds \$1,600 is taxed at the parents tax rate, not the lower rate that would have applied for the child. However, once the child has reached the age of 14, appreciated assets (i.e. marketable securities) can be transferred to the child's UGMA/UTMA account and then sold, taking advantage of the child's lower tax rate.

Certain trusts are also possible tools in education planning. The advantage in using a trust is that it can restrict the child's access to the money until age 21, or beyond. However, the trust income tax structure not only curtails the over-all tax savings, but essentially penalizes trusts that accumulate income.

### **Financing Higher Education**

**Section 529 Qualified Tuition Plans.** There are a variety of mostly state-sponsored plans that allow parents and grandparents to set up college accounts for children and grandchildren before they reach college age. Once established these accounts qualify for favorable federal (and often state) tax benefits, which can ease the burden of paying for college. Additionally, these plans have no AGI-based limitations, making them attractive for higher income parents and grandparents.

There are two basic types of 529 plans established by the states: a) prepaid tuition plans and b) savings plans. 529 plans established by eligible educational institutions can only be prepaid tuition plans; these institutions cannot set up savings plans.

A **prepaid tuition plan** locks in the price of covered educational expenses at today's prices, thus insuring against college cost inflation. The tax benefits are a nice bonus. In contrast a **savings plan** is best thought of as a tax-advantaged way to build up a college fund. Savings plans do not lock in the cost of covered educational services. For both types of plans the federal tax advantages are identical.

**Prepaid tuition plans** allow individuals (generally parents) to prepay the education costs of a designated beneficiary (generally a child) at specified institutions and thereby lock in the price. The prepayments are invested by the 529 Plan. The investment return is guaranteed to keep pace with inflation in the cost of the covered educational expense – nothing less, nothing more. If the 529 Plan does not, in reality, earn enough to cover the

tuition, there is no obligation to make further payments. If, however, the Plan earns more than enough to cover the cost of the educational expenses, the plan gets to keep the excess. In either case, once the designated beneficiary enters college, the covered costs of the beneficiary will either be waived or paid for by the 529 Plan.

Unlike prepaid tuition plans, **Savings Plans** do not guarantee that the college expenses will be fully covered, but they do provide tax favored savings accounts for higher educational expenses. The account owner decides how much to contribute to the savings plan, chooses among the plan's investment options and monitors performance. When the beneficiary enters college, the account is drawn down to pay some or all of the college expenses.

Section 529 plans also have favorable gift and estate tax planning aspects. The annual gift tax exclusion (\$11,000 in 2005) still applies to their funding, but a special feature of these plans allows contributions to be treated as being made over 5 years, allowing a \$55,000 contribution in a year for each beneficiary (but limiting the availability of annual exclusions for the next four years). A married couple would thus be able to fund each beneficiary's account with \$110,000, allowing grandparents to fund up to this amount for each grandchild. There are no restrictions on the relationship of the beneficiary. Additionally, a donor can later change the beneficiary of an account, allowing a parent or grandparent to transfer amounts between their descendants as future circumstances dictate. The donor/account owner's estate DOES NOT include the 529 plans value, even though the owner still has control of it, retaining the right to later withdraw the funds or change the beneficiary.

Opening a 529 Plan is easy. An individual can normally open an account by dealing directly with the state plan. The use of a broker or financial advisor is not required, although a number of plans have now been established to accommodate broker-sold accounts. An individual can normally open a "no load" account directly from the sponsoring state, or, if he prefers, through a broker. Once a specific plan is selected, the account owner completes the enrollment form, which typically includes naming the beneficiary, primary and successor account owners, and selecting an investment option or options. Once the initial contribution is made, most plans allow account owners to make future contributions via scheduled automatic withdrawals from a bank account or on an as desired basis.

**Coverdell Education Savings Accounts.** Another savings plan which provides tax free earnings on funds used for qualified education expenses is the Coverdell Education Savings Account (ESA).

Compared to 529 plans, ESAs have several disadvantages. The annual contribution limit for ESA's is only \$2,000, beneficiaries must be under 18 years of age, and they are subject to limitations based on the donor's income. The \$2,000 contribution limit is phased out ratably for a contributor who is a joint filer with MAGI of over \$190,000 or a single filer with MAGI over \$95,000. Same year contributions can be made to both an ESA and a 529 plan established for the benefit of the same beneficiary. However, ESA's

do have a place in education planning in that they are the only education benefit that can be used for kindergarten, elementary school, middle school or high school education costs. Families may want to consider using ESAs for elementary and secondary school expenses and other education savings options for postsecondary education.

The planning for meeting educational expenses involves many options, some with significant tax advantages. This planning must also take into account various loan options and the effect of the strategy on the federal and the institution's calculation of eligibility for financial aid. Planning to meet educational expenses is as likely to require professional assistance as does estate planning.

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