

College or Bust – Part 2

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Published July of 2004 in the Sparks Tribune, Sparks, NV

In the last week's column we focused our attention on one of the two types of 529 plans, namely the College Savings Account. This week we will finish up our discussion on 529 plans by covering the Prepaid Tuition Plan, and then conclude with the remaining options most commonly used in education planning.

Prepaid Tuition Plans are offered by most states and will cover tuition associated with going to an in-state public college or university. Private universities are now also able to offer prepaid tuition arrangements, but not 529 savings accounts. There are currently around 300 private colleges and universities that are offering their own prepaid arrangements, so it is best to contact the college directly and find out what program they offer.

The Prepaid Tuition Plan may be more attractive than other options if you don't want to worry about how the money is invested or how it is performing. Under this plan you are purchasing tuition credits or certificates for a designated beneficiary that entitles him or her to pay tuition in the future based upon today's rates. So, a prepaid tuition plan has less risk than other plans since it guarantees tuitions at current-year prices, regardless of what it may cost in the future. For example, if a family purchases shares worth half a year's tuition at a state college, these shares will always be worth half a year's tuition -even 10 years later, when tuition rates may have doubled. Although safer, one downside of this plan is that it only covers tuition costs, whereas the College Savings Account can be used not only for tuition but also for qualified higher education expenses such as room and board.

A second concern may be, "what if my child decides not to attend the school that I have already paid for. or what if the school doesn't accept them?" If the school your child decides to attend does not participate in the Prepaid Tuition Plan, you can get a refund based on (he initial purchase price adjusted for investment performance, hi most cases, the investment vehicles arc bonds so investment returns are usually similar to one another. As a result, you may get more or less than your initial investment, depending on how well the plan's investments have been managed- If te new school participates in the plan the money can be rolled to the new school, but you have no guarantee how much the credits will be worth or how the tuition credits will be applied at the new school. Additionally, there are usually administration fees and penalties to terminate the plan. To check your own slate's plan for details and lo get more information on Prepaid Tuition Plans please visit www.finaid.org. If you would like more information about the Nevada Prepaid Tuition Plan go to [http://ncvadatrcasurcr.Qov."Collcgc/prcpaid.asp](http://ncvadatrcasurcr.Qov.).

A third risk is that a Prepaid Tuition Plan might close before you have finished buying the credits. This occurred in October of 2003 when the state of Ohio suspended its prepaid tuition plan. The reason for the closure was the double-digit tuition increases and sub-par investment returns. The closures have also happened in Kentucky, West Virginia, Texas and Colorado.

If you are looking for more control over your investment choices the Coverdell Education Savings Account, previously known as the Education IRA, may be right for you. The Coverdell Education Savings Account is similar to (he Roth IRA, except it has the sole purpose of providing an investment vehicle for education expenses in the eligible educational institution. As we will discuss, an eligible educational institution can be either an eligible pos(secondary school or an eligible elementary or secondary school (TRA Publication

970).

Like a Roth IRA, your contributions are nondeductible and they are allowed to grow tax free and be paid out tax free as long as the dollars are used for qualified higher education expenses, similar to a 529 plan. According to Michael S. Lee, a shareholder in the Chicago law firm of Schuyler, Roche, and Zwirner, they can also be used for qualified elementary and secondary education expenses (IRS Publication 970). Generally, qualified elementary and secondary education expenses come in three categories: expenses that must be incurred, expenses required or provided by the school, and computer expenses. Expenses that must be incurred, are items such as tuition and fees, books, supplies, equipment, tutoring, and services for special needs students. Expenses required or provided by the school are room and board, uniforms, transportation, and supplementary items and services. "Computer expenses" is an interesting category. If used by the designated beneficiary and his or her family during any year that the beneficiary is in school, it can include equipment, software and Internet access. If you are a computer game junkie, don't get any ideas because, unless the games are predominantly educational in nature, they aren't included.

The contributions to the Coverdell Education Savings Account (ESA) can be invested in whichever investment vehicle the account owner chooses (except investing in the life insurance contracts). So, if you want to invest in your favorite mutual fund, stock, or bond, you can do it. There are two drawbacks to this plan. First, 2004 contributions are limited to \$2,000; however, it can be paid as late as April 15th of 2005. Second, your ability to open and contribute to an Education Savings Account is limited by your modified adjusted gross income. There is a phase out of how much a person can contribute to the Education Savings Account and it is based upon the person's modified adjusted gross income. For 2004, the amount a single filer can contribute phases out starting at a modified adjusted gross income of \$95,000 and ending at \$110,000. For married taxpayers filing jointly the range is \$190,000 to \$220,000 (www.irs.ustrcas.gov). Remember, the fees, charges, and expenses will vary depending on the investments you choose and the institution where you open an ESA. However, because of the fairly low contribution limits, even small annual fees or expenses could make a big difference in the value of your investment over time.

It is also possible to save for education through savings bonds. Under section 135 of the Internal Revenue Code, interest on series EE bonds issued after 1989 and Series I bonds used to finance qualified higher education expenses of the taxpayer, the taxpayer's spouse and taxpayer's dependents, is excludable from gross income. Unlike the 529 plan and the Education Savings Account, in which the account owner and the beneficiary are two different people, the exclusion is not available to the owner unless he or she was the original purchaser of the bonds or the purchaser's spouse. So the exclusion isn't available if the bonds are purchased by a parent, and then placed in the child's name. Also, to qualify for the exclusion, the person must have purchased the bonds after reaching age 24. Of course, this exclusion is subject to phase outs based upon modified adjusted gross income. For example, in 2004, the full interest exclusion is only available for married couples filing joint returns with modified adjusted gross incomes of up to and including \$89,750 and for single filers with modified adjusted gross incomes of up to and including \$59,850. In a family situation, it's possible for mom and dad, after one of them reaches 24, to purchase EE bonds or I bonds in their own name. Then later, if mom and dad are paying for college for their child, they can exclude interest from these bonds, if it is used to pay the qualified higher education expenses of their child.

Similar to the 529 Plan, you still obtain tax-free buildup and no income tax liability on the interest received from EE bonds or I bonds if it is used to pay for qualified higher education expenses. Although the thought of owning bonds may not sound very exciting, they provide something that the 529 plan doesn't, flexibility. Suppose you purchase EE bonds or I bonds and end up not using the interest to pay for qualified higher education. You still have the benefit of the growth and the value of the bonds, but you do not have to pay a penalty for using the money for something other than qualified higher education expenses. You do however lose the benefit of tax exclusion.

Finally, let's discuss accounts established under the Uniform Transfers to Minors Act, (UTMA) account. It is important to note that state laws govern UTMA accounts so it is important to know the specifics in your state. UTMA accounts were established for the transfer of any kind of property, real or personal, tangible or intangible, to minors. According to Mr. Lee, this means that minors can be shareholders in an S corporation, members of an LLC, hold limited partnership interests, and hold stock. The custodian of the account, which is oftentimes a parent, has complete control over the account assets, and they are able to make investment

decisions in the UTMA account until it is terminated by the beneficiary upon reaching the age of 18 in the state of Nevada, or 21 in other states, according to the governing law.

While there are no investment restrictions with respect to UTMA's, and generally they are less expensive to establish than a trust, there are some major drawbacks. First, transfers to UTMA's are subject to gift tax restrictions. Gifts in excess of the annual exclusion amount, \$ 11,000 for 2004, and the unified credit are subject to gift tax. Second, UTMA's established for children under the age of 14 are subject to the "kiddie tax" rules. The tax rules for children are found in IRS publication 929. For children younger than 14, the first \$750 in earnings in a custodial account is tax-free. The next \$750 in earnings is taxed at the child's federal tax rate. Any earnings over \$1500 are taxed at the custodian's federal tax rate. For children over 14, the first \$750 in earnings is still tax-free, and all earnings after that are taxed at the child's tax rate. Also note that IRS regulations require all minors 14 or older to sign their own tax returns.

Third, the beneficiary actually gets the assets at age 18, or in some states 21. The thought of an 18 year old having control of that money usually scares parents once they experience their child's metamorphosis into a full-blown teenager. Perhaps most importantly, when comparing UTMA accounts to the 529 plans, you can't change beneficiaries.

As we review some of the vehicles available to fund a child's education, the basic features that differentiate one plan from another are: 1) control of investments, 2) tax free distribution if used for qualified educational expenses, 3) ability to change beneficiaries, 4) annual contribution limits to the account, 5) withdrawals and withdrawal penalties, and 6) broad acceptance by many colleges and universities. Be aware that the law exempting qualified withdrawals from federal income tax expires on December 31, 2010. Unless Congress and the President take action to extend the provisions of this law, withdrawals from 529 plans will not be tax-free beginning in 2011. Keep this in mind if you have younger children who will be in college after 2010.

You might consider prioritizing these six features as a way of narrowing down which plan(s) are best for you and the child you are trying to benefit. A combination of plans may be the best solution, so consider consulting with your financial advisor to design an education savings program that is best for you.