How Should I Save for My Child's Education Costs?

Topic:	Tax Efficient Ways to Save for Education Expenses
Author:	Samuel D. Swisher, JD
Sponsor:	Vantage Financial Partners Limited
Date:	March 18, 2005
Executive Summary:	Saving for your child's education expenses is usually the first big expense that the executive must begin funding as early as possible. This article explores the various tax advantaged options that are available to the high bracket taxpayer for funding education.

Many corporate executives seem very comfortable with the retirement savings strategies offered by their company in the form of 401(k) plan, deferred compensation plans, restricted stock and the like. However, this is not the case for the second biggest expense of most parents: saving for your children's college education. This white paper will explore the various alternatives open to the corporate executive who wants to employ the smart ways to save for college. It will discuss the best use of company plans and also explore other non-corporate avenues that are tax advantaged.

Company Plans

Maximize 401(k) contribution

While the 401(k) plan was designed to allow a supplemental retirement source to social security, the benefits can be extended to provide a source for college education funding. It is therefore wise to maximize your allowable 401(k) contribution. Most company 401(k) plans will allow employees to borrow from their accounts, so when college time arrives one source to tap is to borrow from you plan. The interest charged on the loan is essentially paid to back into the employee's account, but it is non-deductible. This is a good source of funds that does not trigger any current taxable income. One note of caution, however, if you leave the company while the loan is outstanding, the loan must be entirely repaid or a taxable distribution will result to the extent of the unpaid amount.

Time your deferred compensation

Many companies offer salary and/or bonus deferral programs. The recently enacted tax act in 2004 reduces the flexibility somewhat, but it is still possible in many plans to time the distributions to coincide with the college years of your children. While these distributions trigger taxable income, the earnings will accumulate tax-deferred before distribution.

Other Tax Advantaged Savings Specifically for Education

Coverdell Education Savings Account (ESA)

Coverdell ESA's are generally not applicable for corporate executives due to the income limitation; however, these are good vehicles for grandparents or other relatives that might have more moderate incomes. In addition, ESA's should be done as early as possible to maximize the tax deferral benefit.

If your Modified Adjusted Gross Income (MAGI) is less than $110,000 ($220,000 if filing a joint return), you can establish a Coverdell ESA to finance the qualified education expenses of a designated beneficiary. There is no limit on the number of separate Coverdell ESA's that can be established for a designated beneficiary. However, total contributions for the beneficiary in any year cannot be more than $2,000. In addition, no further contributions can be made after the beneficiary turns 18 years old. This benefit applies not only to higher education expenses, but also to elementary and secondary education expenses.

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed. In addition, like the “529 Plan”, distributions are tax free if made for qualified education expenses. If distributions exceed the allowable expenses, then it is subject to tax and to a 10% penalty. However, the excess could be rolled over to another relative for future educational use.

Qualified Tuition Plans or “529 Plans”

Unlike the Coverdell ESA, the Qualified Tuition Program “QTP” or “529 Plan” is not limited by income and depending on the state has very high annual contribution limits. Consequently, the “529 Plan” will be the most beneficial program to fund the college needs of your children. Like the Coverdell, payments made into the plan are not deductible for federal income tax purposes, but the earnings build up tax deferred until distribution for college. Distributions for “qualified education expenses” are never taxed. Also, the best use of this program is to start early to maximize the tax deferral.

The programs are set up by each individual state and one can participate in any state program, but certain state tax benefits are only allowed for local residents. For example, in Illinois for 2005 and thereafter, a taxpayer may deduct up to $10,000 annually from his Illinois taxable income for payments to their College Illinois! Plan. Distributions are also free of Illinois income tax. There is no requirement that the student attend an Illinois institution.

Contributions can be made by non-parents such as grandparents, and other relatives and qualify for the current gift tax exclusion. For gift tax purposes, in 2004 a contributor may contribute more than the annual gift tax exclusion of $11,000 ($22,000 for a joint gift by a spouse) to a qualified tuition program on behalf of any one person, by electing to treat up to $55,000 ($110,000 joint) of the contribution for that person as if you had made it ratably over a 5-year period. The election allows you to apply the annual exclusion to a portion of the contribution in each of the 5 years, beginning in 2004. You can make this election for as many separate people as you made 529 contributions. For 2005 and beyond the 5 year election applies to the then annual gift tax exclusion which increases with inflation.

While there are no limits to the amount that can be contributed to a 529 account by the federal tax code other than for qualified education expenses, most states limit the amount to between $100,000 and $250,000 per beneficiary. Any amounts not ultimately spent for qualified education expenses must be taxed and are also subject to a 10% penalty. However, excess amounts can be rolled over to another member of the beneficiary’s family (e.g. brother, sister, spouse or child of beneficiary). Thus, a large “529” plan can be rolled over to the younger children of the executive and as well as to their grandchildren without penalty.

Tuition and Fees Deduction

If the executive has to tap other sources of funds for college besides the Coverdell and 529 Plan, there is one current tax benefit for low and middle income taxpayers. In addition, if the child has income while in college and uses it for qualified education expenses, a deduction for the student is possible if the child cannot be claimed as a dependent on the parent’s tax return.

For taxpayers with MAGI of not more than $65,000 ($130,000 for married filing jointly), they can deduct the amount of "qualified education expenses" up to $4,000. If your MAGI is larger than $65,000 ($130,000), but is not more than $80,000 ($160,000 if you are married filing jointly), your maximum tuition and fees deduction is $2,000. No tuition and fees deduction is allowed if your MAGI is larger than $80,000 ($160,000). Qualified expenses include tuition and fees for post secondary education for a family member, but do not include room and board. The deduction is before adjusted gross income so that taxpayers who do not itemize deductions can still take advantage of this deduction.

Other College Savings Methods

Gift Money to Your Children

For high bracket taxpayers who do not expect to be eligible for financial aid for college, it may be advantageous to gift money to your children to take advantage of their lower rates. Parents can gift $22,000 annually to their children free of gift tax. However, beware of the "Kiddie Tax" that requires investment income of a child under 14 in excess of $1,500 to be taxed at the parents higher bracket. If the child is under 14, one can buy US savings bonds and elect to defer reporting the interest income until after the child reaches 14. Assets in the name of the child, however, will adversely affect financial aid opportunities compared to keeping the assets in the parents name. Thus, if financial aid is contemplated this strategy and the one below are not recommended.

Have Child Start a Roth IRA

If your child has a part time or summer job, you may want to encourage him or her to set up a Roth IRA with a portion of the earnings. A child may contribute 100% of his earned income up to $3000 to a Roth IRA in 2004 (it can be contributed as late as April 15, 2005). Not only does this establish a good savings habit for your child, it also allows the earnings to accumulate tax free and the amount can be withdrawn without penalty for qualified post secondary education expenses. However, the Roth IRA must be in existence for 5 tax years before any distribution can be made. If there is not a 5 year window until college, a traditional IRA could be used.

If the child is unable contribute the all of his wages toward the Roth contribution, some parents will actually give the child a gift equal to the maximum allowable IRA contribution to maximize the benefit of tax deferral. For example, the child earns $2,500 in wages during the summer and needs $1,000 to cover expenses. The child could contribute $2,500 into a Roth IRA if he had the cash; however he has only $1,500. The parents could give the child a gift of $1,000 and it could be used to fund the Roth IRA to the maximum extent. Even if the money is not used for college, it is already earning tax deferred for retirement which will result it much larger retirement nest egg for the child and his eventual family. However, like other assets in the name of the child, it may reduce any financial aid possibilities.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

VANTAGE FINANCIAL PARTNERS LIMITED
Nine North Vail Avenue, Arlington Heights, IL 60005-1430
(847) 590-9191 Fax (847) 590-9009
www.vantagefinancial.com

Securities offered through Linsco/Private Ledger
Member NASD/SIPC