"Advising on College Funding"

"It is best to start the college investment process when your children or grandchildren are young, but it's never too late to begin. The earlier you start, the greater the potential impact compounding has on your savings," opines Lawrence Simon, principal with Margolis & Company in Bala Cynwyd, Pa. With that in mind, Randi Grant, director of taxation and personal financial planning with Berkowitz Dick Pollack & Brant in its Fort Lauderdale, Fla., office, offers a caveat. "Before determining what funding vehicle to choose, there should be a clear understanding of the parent's expectations and goals for their children's expectations and goals for their children's education, as well as a current assessment of the client's current financial plan."

The Funding Vehicle Choice

To decide on what funding vehicles should be used, Peri Ann Aptaker, principal and director of tax services at KLR (Kahn, Litwin, Rensa & Co.) in Providence, R.I., looks at the age and number of children, age and health of the parents, parents' and children's income and assets, and other funding sources, such as from grandparents or expected inheritances. Simon advised before selecting an option ask: What are the tax benefits? Who controls the funds? How much risk in involved? Are there contribution limits? Gloria Birnkrant, partner at NSBN in Beverly Hills, Calif., adds also to consider whether the client wants to manage the funds.

Alan Goldfarb, chief financial strategist at Weaver and Tidwell Financial Advisors, in Dallas, says, "There are many vehicles that can be used to fund these educational expenses, including 529 plans, UGTMA plans, 2503© trusts, Coverdell IRAs, and parental assets."

Robin Byford, a registered principal with the Financial Institutions Division of Raymond James financial services in Oklahoma City, typically finds that 529 plans are best suited due to the tax-free growth. She points out that Coverdell savings accounts have a much lower contribution limit per year, and that UGMS/UTMA accounts have other tax consequences on earnings, as well as a loss of control upon the beneficiary reaching majority.

Simon identifies the following distinct advantages of 529 plans:

1. Earnings used for qualified higher education expenses are free from federal taxes.
2. Parent in control of the funds.
3. Generous contribution limits are available regardless of income level.
4. Ability to select among the investment strategies available.
5. Child may pick any accredited college, university, or vocational school.
6. Unused portion may be transferred to another family member.
7. Contributions are excluded from a taxable estate, and may not be subject to gift taxes.
8. In certain state, earnings used for qualified higher education are free from state taxes.

Dale Baumann, principal with Windham Brannon, in Atlanta, points out that every estate has established at least one Section 529 plan, with each establishing maximum contributions and some allowing income tax deductions

As to Coverdell accounts, Baumann points out that donors can contribute up to $2,000 in combined total for a single beneficiary during a calendar year. Similar to 529 plans, he explains, the contributions are non-deductible, and distributions of income earned on the assets of the account aren’t subject to income tax if they are used to pay for qualified expenses. He does add that an individual’s ability to contribute to a Coverdell account is phased out if the individual is at a certain level of income.

Another technique is identified by Baumann is to use Series EE bonds to pay for tuition and fees of a dependent, as the earnings will not be taxed for deferral tax purposed provided the owner's income for the year of payment is less than a certain phase out level. He notes a restriction on Series EE bonds that the maximum face amount that can be purchases in one year is $30,000.

One step that Baumann suggest parents may want to consider is purchasing term life insurance to cover the education costs in case of a premature death.

Comparing 529 plans

Aptaker consider a number of criteria when comparing 529 plans, including program type, enrollment period, investment manger, eligibility requirements such as state residency, minimum and maximum contribution limitations, investment options, investment performance, investment management fees, whether there is backing by the full faith and credit of the state or there is a guarantee, enrollment and application fees, in-sate tax benefits, and ease of contact via Web site or telephone.

Goldfarb believes the best criteria for comparing 529 plans includes tax breaks from the issuing state, investment choices, investment performance, and all associated costs.

Bauman says if a client doesn't have a significant period of time for the assets to grow, it may not be worth the time and trouble to establish a 529 plan. However, he says that might not be the case where the state provides an income tax deduction for contributions or the creation helps for financial aid purposes. Two sites that help when comparing 529 plans are Savingforcollege.com and Collegesavings.org.

Relatives Pitching Inc

For relatives interested in helping, many of the same funding vehicles are available, observes Baumann. Goldfarb points to direct gifts to the children, pre-funding any investment vehicle, paying tuition directly to the educational institution, or making inter-family loans available to the child. With regards to low-interest loans, Baumann suggests some or the entire loan to be forgiven over the years qualifying for the annual exclusion gift amount in the year of forgiveness.

Aptaker believes 529 plans are a great vehicle for grandparents and other relatives. “First, for those with expected taxable estates, any money contributed to a 529 plan is removed from the estate for estate tax purposes. The beauty of placing money in a 529 for a grandparent is that should their personal circumstances change, they can actually get their money back (subject to income taxes and certain penalties).”

Birnkrant points out that, “If the parents have maxed out what can be contributed to a 529 plan and the institution that the child has selected to attend exceeds the amount that was funded, relatives can pay tuition directly to the institution and not have it count towards their annul gift, allowing them to exceed the $12,000 per year.”

Simon and Grant both caution that those wishing to make a contribution to a loves one’s college fund shouldn’t exceed $60,000 per beneficiary in the first year of a five-year period if they want to avoid gift tax consequences $120,000 per married couple via gift-splitting).

In that regards, Baumann cites Ltr. Rul. 200602002, in which the IRS ruled that the prepayment of tuition to a qualified educational institution qualified for the unlimited gift and generation skipping-tax exclusion even when the payment was meant to cover tuition for years beyond the year of the transfer. According to Baumann, grandparents were allowed to transfer funds to pay for 12 years’ worth of private elementary education for their six grandchildren in one year. “Utilizing this technique, grandparents could make significant transfers to cover education expenses without utilizing any of the $12,000 annual exclusion amount,” explains

Baumann. He adds, "Such a transfer isn't without risk since the payment was non-refundable and didn't guarantee enrollment for the grandchildren."

Financial Aid and Scholarships

Byford points out that ownership of a 529 plan can affect financial aid. "The federal government and public universities use the Expected Family Contribution (EFC) formula to determine how much of a child's college expenses a family is expected to cover. The EFC formula assumes that a large percentage of family income is available to pay for college, and therefore considers only around five percent of a parent's savings and 35 percent of the child's assets in the equation. Because of this, having an account such as a 529 that is considered an asset of the parent versus the child is more beneficial as far as receiving financial aid from an ownership standpoint compared to other savings vehicles, such as the education savings accounts."

Simon agrees, and points out that traditional 529 savings plans are owned by account owners and not students, while 529 prepaid plans UGMA/UTMA and Coverdell accounts are owned by the student, for financial aid purposes.

With regard to private schools, Byford warns they may have different guidelines when using their own financial aid pools. She also points out that distributions taken from a 529 also affect financial aid.

Baumann believes that with planning it may be possible to remove 100 percent of the custodian account and 529 plan from EFC formula. He explains, "For example, dependent students-or-grandparent-owned 529 plans aren't currently included in the EFC formula. Thus, a 529 plan could be established by grandparents, or alternatively, 529 plans owned by parents could be transferred to the beneficiary and the balance wouldn't be included when determining the EFC. Another possibility is for the custodian of a UTMA/UGMA account to transfer the assets of the account to a student-owned 529 plan. The result would be to generally remove the EFC calculation, thereby increasing the chance for obtaining financial aid.

Because, according to Aptaker, many schools count 100 percent of a child's assets as available for their education, she recommends for children who have accumulated assets in their name, such as UTMA accounts, these assets should be spent down for their expenses prior to reaching college age. "Frequently, I meet with parents who are paying for their children's private grade or high school educations out of their own funds because they have a desire to 'save' their child's money for college. This strategy actually hurts their children applying for financial aid," she explains.

With respect to the parent's assets Aptaker indicates there are certain ones that aren't counted by some institutions as available for their children's education. She advised if the situation permits, assets can be repositioned into annuities and life insurance, this exempting them from being counted as available for financial aid. Baumann points out qualified retirement plan assets and home equity in a primary residence are also not generally considered.

With regard to any assets the child has in trust for their benefit, Birnkrant provides this caution. "Be sure that there are restrictions on trusts that prevent the child from accessing trust principal to pay tuition. If the determination if left up to a separate trustee's discretion, those assets will not count against the child in most cases."

For possible qualification for scholarships, Aptaker suggests every parent should complete the federal FAFSA (Free application for Federal Student Aid), pointing out that most schools will not consider their child for merit scholarships if it isn't completed.

Latest Wrinkle

Goldfarb predicts recent legislative changes regarding the Kiddie tax will place more emphasis on suing 529 plans and various other funding vehicles. Aptaker agrees. Her reasoning is, “These education savings vehicles permit the assets to grow tax-free, while assets owned individually by students under the age of 24 will be taxed at their parents’ income tax rate.”

Simon also asks, “Why pay the same tax rate and lose control of your funds when your child reaches the age of maturity? Your contributions are irrevocable, your child can use the funds for any purpose, and you may reduce financial aid eligibility because the assets are in your child’s name.”

Because of the changes, Baumann suggests possible employment in the family business. “To the extent the prospective student has not otherwise utilized his or her standard deduction, income earned from employment will generally not be taxed. In addition, there is generally an exception from the application of the Kiddie tax rules for earned income, and beginning in 2008, if an individual between the ages of 19 and 24 earns more than half of their support, the Kiddie tax rules will not apply at all. Thus, income can generally be shifted to a lower income taxpayers.” He adds, “It also may be possible to establish an employer-sponsored education program and provide $5,250 per year of tax-free tuition reimbursement.”

Start Early, But…..

“With college expenses rising each year on an average of seven percent, the cost of college is rising significantly. By starting early, clients can use the benefit of compounding interest and time to their advantage to help make a larger dent in their college costs,” advises Byford.

This should be contrasted to Grant’s caution that “Before considering saving for college, a planner should look at the client’s fundamental financial planning needs, such as disability/life insurance and funding of employer-sponsored qualified plans.” Baumann believes you must always remember that clients usually have two competing goals that they need to deal with simultaneously: funding education for their children and their own retirement.