Education savings

In brief

EDUCATION SAVINGS TECHNIQUES

Saving in the parents' name

A number of options exist for parents to save in their own name, including:

- **IRAs and Roth IRAs.** Distributions from either of these retirement savings plans can be used for qualified higher education expenses penalty-free.
- **Stocks, bonds, and mutual funds.**
- **Government savings bonds.** The proceeds of certain Series EE and Series I U.S. Savings Bonds are tax free for low- and middle-income taxpayers if used for qualified higher education expenses.
- **Life insurance.** A policy's cash value grows income tax deferred, and the income tax-free death benefit provides financial security against premature death.

Coverdell Education Savings Account (CESA)

CESA assets grow tax deferred, and earnings are income tax free when used to pay qualified education costs incurred by a child while attending elementary school, high school, or college. Annual contributions are limited to $2,000 per child, subject to a phaseout for high income earners. CESA assets must be distributed to the beneficiary upon reaching age 30.

Custodial arrangement (UGMA and UTMA)

Created under a state's Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA), transfers to a child are held and managed by a custodian who can spend the funds for the child's benefit until the child reaches age of majority, which is 18 or 21 in most states.

Irrevocable Trust

The trustee manages and distributes assets for the child's benefit according to the trust's terms. Gifts to two types of trusts can qualify for the gift tax annual exclusion:

- **§ 2503(c) Trust.** Property transferred to a § 2503(c) trust qualifies for the annual exclusion even through the child cannot immediately withdraw funds. When the child turns 21, the child has the right to withdraw trust assets.
- **Irrevocable Trust with Withdrawal Rights.** The trust can give the trustee discretion to make distributions for a variety of reasons – including paying its beneficiaries' education expenses. The trust does not have to terminate or make distributions at a particular age of the child, but a trust beneficiary must be able to immediately withdraw the gift for it to qualify for the annual exclusion.

529 Plans

- **Prepaid tuition plans.** This plan protects against inflation in college tuition by allowing the purchase of college tuition credits for future use at today's prices.
- **College savings plans.** In this more popular type of 529 plan, cash contributions are invested and managed by a state-selected money manager for the benefit of the child. The account grows tax deferred, and earnings used for qualified education expenses are income tax free. See the following two pages for thorough analysis.

529 COLLEGE SAVINGS PLANS

Getting started

- **Eligibility.** Anybody can set up a 529 plan and anybody can be the beneficiary, including the owner themselves.
- **Multiple state plans.** 529 plans are established by the states. There is no overarching restriction on using another state's program, but there are a few programs that require that the owner or beneficiary be a resident of that state. Most programs do not have a residency requirement.

Contributions

- **Cash contributions.** Contributions must be made in cash.
- **Contributions are gifts.** Contributions made by the owner are considered gifts to the beneficiary. The owner of the account can use their annual gift exclusion on contributions to avoid gift taxes.
- **Five-year election.** If the owner contributes more than the annual exclusion, they can elect to treat the gift as if it is spread over the next five years and use up to five years of annual exclusions at one time. This allows an account-owner to gift up to $75,000 into a 529 plan in 2021 ($150,000 if married), although this will leave them with no annual exclusion to use for other gifts to that beneficiary for the next four years. Account owners can make this election when they file their Form 709 gift tax return.
- **Third-party contributions.** In some cases, third parties can also make contributions to the 529 plan (for example, parent owns a 529 plan benefiting their child, and a grandparent makes contributions). These third-party contributions are also considered gifts to the beneficiary. A third-party contributor can elect to use five years of annual exclusions. Parties should check with the 529 administrator to make sure it allows contributions from third parties.
- **Aggregate contribution limits.** Each state has maximum aggregate contribution limits that typically range between $300,000 and $500,000. These limits only apply to contributions and do not apply to account earnings.
- **State income tax deductions.** There is no federal income tax deduction for 529 contributions, but many states allow a state income tax deduction for all or a portion of contributions. This is to encourage residents to use their home state's programs, so typically taxpayers must use that state's 529 plan to get the deduction. The specific rules for residency concerning the account owner, beneficiary, and contributor can be different from state to state, so taxpayers should always consult a tax professional.

Investments

- **Investment options.** 529 account owners can choose among investment options that are offered by the plan administrator.
- **Changing investments.** Once the owner of the account has selected an investment option, they cannot redirect how their contributions are invested more than two times in any calendar year.

Distributions

- **Distributions.** Distributions for qualified higher education expenses are tax free to the owner and beneficiary.

- **Qualified higher education expenses.** Qualified higher education expenses include:
  - Tuition, fees, books, supplies, and equipment required for the beneficiary's enrollment or attendance at an eligible educational institution.
  - Room and board costs for students who are enrolled at least half-time at an eligible educational institution. These costs can be for on-campus or off-campus housing, but are limited to the amounts that the school uses in their Cost of Attendance (COA) calculation for financial aid purposes. These COA amounts can be found on the financial aid page of a school's website or by contacting the school's financial aid office directly.
  - Certain expenses for the purchase of computer or peripheral equipment, computer software, or internet access or related services. The equipment, software, and services must be used primarily by the beneficiary while enrolled at an eligible educational institution and the software must be predominantly educational in nature (for example, no software designed for sports, games, or hobbies).
  - Expenses for special need services that are incurred in connection with enrollment or attendance of a special needs beneficiary at an eligible educational institution.
  - Up to $10,000 for tuition expenses in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.
  - Expenses for fees, books, supplies, and equipment required for the participation in an apprenticeship program. The apprenticeship program must be registered and certified with the Secretary of Labor under Section 1 of the National Apprenticeship Act. Please see www.apprenticeship.gov for further information about apprenticeships.
  - Amounts paid as principal or interest on any qualified education loan of the designated beneficiary or a sibling of the designated beneficiary. These tax-free distributions to pay student loans are limited to $10,000 per individual for their lifetime. This means that 529 distributions can pay up to $10,000 towards each of multiple siblings' student loans without changing beneficiary designations. A beneficiary is not able to take a deduction for any student loan interest that was paid through a tax-free 529 distribution (see below for more information regarding student loan interest deductions).

- **Eligible educational institution.** An eligible educational institution is any college, university, trade school, or post-secondary educational institution that is eligible for Title IV federal student aid programs. Besides United States schools, this includes some international schools used in study abroad programs. The Office of Federal Student Aid publishes a sortable list of institutions with Federal School Codes that participate in Title IV Federal student aid programs at ifap.ed.gov/ifap/fedSchoolCodeList.jsp. An international school's eligibility for tax-free 529 distributions should be verified with study abroad programs.

- **Distributions not used for education.** If money distributed from a 529 plan is not used for qualified higher education expenses, then all earnings in the distribution will be taxable. All distributions are part earnings and part return of contributions in proportion to the underlying account. Unless the nonqualified distribution is due to the beneficiary receiving a scholarship, attending a United States Military Academy, dying, or becoming disabled, there will also be a 10% penalty applied to the earnings in the distribution.

Financial aid

- **FAFSA.** Parent-owned 529s and dependent-student-owned 529s must be listed on the Free Application or Federal Student Aid (FAFSA). Whether the 529 account is owned by the parent or the dependent student, it will always be listed as a parent-owned asset on the FAFSA form. The most a 529 plan will affect federal student aid is by 5.64% of the account value. For example: if a parent owns a 529 plan worth $100,000, the most that account will affect federal student aid is by $5,640, meaning the student might receive $5,640 less in federal student aid.
- **Grandparent-owned 529.** If a grandparent owns a 529 account (or anybody besides a parent or dependent student beneficiary), then the account is not listed as an asset on the FAFSA. However, any distributions taken for student expenses may appear as untaxed income to the student on future FAFSA forms. For example, if a student-beneficiary received a distribution from a grandparent-owned 529 plan for education expenses in one year, that distribution must be listed as untaxed income on the FAFSA for the following school year, assuming the student is still in school. The student's financial aid will be lowered by 50% of the income that the student received.

Estate planning

- **Not included in parent's or grandparent's estate.** Contributions made to a 529 are generally not includible in the contributor's estate (unless the contributor is also the beneficiary). If the contributor chooses to spread out the gift to use five years' worth of annual exclusions and then dies before the five years are up, the unused portion is included in the contributor's estate. The account is considered part of the beneficiary's estate.

INCOME TAX CREDITS AND DEDUCTIONS

American Opportunity Tax Credit

- Available for the qualified tuition and related expenses of a student who is enrolled at least half time during the first four years of college.
- Parents can claim separate credits if more than one of their dependent children incur expenses.
- The maximum annual credit per student is $2,500.
- The credit is phased out for parents with income over certain thresholds.
- This credit and the Lifetime Learning Credit cannot be claimed for the same student in the same year.
- Qualified tuition and related expenses paid with tax-free distributions from CESAs and 529 plans cannot be used in calculating the credit.

Lifetime Learning Credit

- Available each year qualified tuition and related expenses are incurred at eligible educational institutions regardless of the student's enrollment status.
- Parents can only take one Lifetime Learning Credit per year no matter how many of their dependent children incur expenses.
- The maximum annual credit per taxpayer is $2,000.
- The credit is phased out for taxpayers with income over certain thresholds.
- This credit and the American Opportunity Tax Credit cannot be claimed for the same student in the same year.

Student loan interest deduction

- Available for interest paid on loans to pay college and graduate school expenses, such as tuition, room, board, books, supplies and equipment.
- Parents can deduct interest paid on money they borrow to pay their own education expenses or those of their dependent children.
- The maximum deduction of $2,500 is phased out for taxpayers with income above certain thresholds.
- The student must have been enrolled at least half-time and seeking a degree when the loan originated.
- Interest paid through tax-free distributions from 529 plans cannot be deducted.

FACTORS TO CONSIDER WHEN SAVING FOR EDUCATION

Control

Most parents want control over the assets because the need to save for education can change over time. For example, a child could earn a scholarship or decide not to attend college. The parents' situation can also change, requiring access to the assets for their needs.

Beneficiary limitations

Some arrangements do not give parents the flexibility to change beneficiaries, or to retain the assets after the beneficiary reaches a certain age.

Investment flexibility

The ability to change how the money is invested over time is important because it may increase total return.

Taxation and cost

The goal of funding education is not to set aside as much as possible for education. It is to save as little as possible to achieve the desired result. The ability to accomplish this objective is reduced if earnings are burdened by taxes and other costs.

College financial aid

A child's ability to receive needs-based financial aid can be negatively affected if the savings plan is considered an asset owned by the parent or child.

Creditor protection

Some parents or children, or both, engage in occupations that expose them to the claims of creditors. Certain education savings plans offer protection from these claims, while others offer none.

Comparison of savings alternatives

FACTOR	PARENT-OWNED CASH VALUE LIFE INSURANCE	IRREVOCABLE TRUST WITH WITHDRAWAL POWERS	2503(C) TRUST	UGMA/UTMA CUSTODIANSHIP
Control of funds and how they are spent	Parent	Trustee, as defined by trust terms.	Trustee, as defined by trust terms until child turns 21. Then, the child has the right to withdraw the funds.	Custodian for the child's benefit until some age, such as 18 or 21. Then, the funds must be transferred to the child.
Beneficiary limitations	Beneficiary can be changed.	Defined by trust terms.	Beneficiary cannot be changed after trust is created.	Beneficiary cannot be changed.
Investment flexibility	n/a	Defined by trust terms.	Defined by trust terms.	Any asset, limited only by state law.
Income tax	Tax-deferred growth; generally tax-free distributions to extent of basis in contract. Tax-free loans as long as contract is in force but will reduce the death benefit.	Taxable to the trust, or beneficiary if funds are distributed. If a grantor trust, taxable to the grantor.	Taxable to the trust, or beneficiary if funds are distributed. If a grantor trust, taxable to the grantor.	Taxable to child, using parents' tax rates if kiddie tax applies.
Estate tax	Death benefit is included in parent's estate if parent is the insured, value of policy is included if someone else is the insured.	None	Included in the child's estate.	Included in the child's estate. If parent or transferor is custodian, might be included in parent's or transferor's estate.
Gift tax	n/a	Contributions qualify for the annual exclusion because beneficiary has a withdrawal right (*Crummey* power).	Contributions qualify for the annual exclusion without giving the child a withdrawal right.	Contributions qualify for the annual exclusion.
GST tax	n/a	Generally, donor must allocate GST exemption.	Contributions that qualify for the annual gift tax exclusion are exempt.	Contributions that qualify for the annual gift tax exclusion are exempt.
Counted in financial aid calculation	No	Yes, considered a child-owned asset.	Yes, considered a child-owned asset.	Yes, considered a child-owned asset.
Creditor protection	Might be exempt, as determined by state law.	Exempt from claims of parents' and child's creditors, assuming child's beneficial interest is completely discretionary.	Exempt from claims of parents' and child's creditors until distribution at age 21.	Determined by state law.

Comparison of savings alternatives (continued)

FACTOR	PARENT-OWNED COVERDELL ESA	PARENT-OWNED 529 SAVINGS	PARENT-OWNED 529 PREPAID
Control of funds and how they are spent	Generally, parent for the child's benefit. All distributions must be made by the time child is age 30.	Parent, unless another owner is chosen.	Parent
Beneficiary limitations	Contributions are limited to $2,000 per child per year and can be made until child is age 18. Beneficiary can be changed.	Beneficiary can be changed.	Beneficiary can be changed.
Investment flexibility	Generally, any asset except life insurance.	Limited to the plan's investment choices but can be transferred tax free to another plan once a year.	n/a
Income tax	Tax-deferred growth, distributions for qualified higher education expenses are Tax free. Beneficiary changes are tax free if to another member of the family that is under age 30.	Tax-deferred growth, distributions for qualified higher education expenses are tax free. Beneficiary changes are tax free if to another member of the family.	Tax-deferred growth, distributions for qualified higher education expenses are tax free. Beneficiary changes are tax free if to another member of the family.
Estate tax	Might be included in the beneficiary's estate.	Might be included in the beneficiary's estate.	Might be included in the beneficiary's estate.
Gift tax	Contributions qualify for the annual exclusion.	Contributions qualify for the annual exclusion. Donor can use five years of annual exclusions in one year, but unused exclusions are recaptured if donor dies before five years expire. Change of beneficiary might result in *beneficiary* being deemed to have made gift.	Contributions qualify for the annual exclusion. Donor can use five years of annual exclusions in one year, but unused exclusions are recaptured if donor dies before five years expire. Change of beneficiary might result in *beneficiary* being deemed to have made gift.
GST tax	Contributions that qualify for the annual gift tax exclusion are exempt.	Contributions that qualify for the annual gift tax exclusion are exempt.	Contributions that qualify for the annual gift tax exclusion are exempt.
Counted in financial aid calculation	Yes, considered a parent-owned asset if the child is dependent. Distributions do not affect eligibility.	Yes, considered a parent-owned asset if the child is dependent. Distributions do not affect eligibility.	Yes, considered a parent-owned asset if the child is dependent. Distributions do not affect eligibility.
Creditor protection	Generally protected in a bankruptcy. Other claims determined by account agreement and state law.	Generally protected in a bankruptcy. Other creditors might be able to claim money in the account. However, some states provide exemptions.	Generally protected in a bankruptcy. Other creditors might be able to claim money in the account. However, some states provide exemptions.

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