

## College and Education Savings – Planning Techniques to Consider

Parents and grandparents should take note of the new breaks that are provided to individuals who make donations to College Savings Plans (commonly known as “Section 529 Plans” after the Internal Revenue Code Section that created them). All of the earnings from these plans grow tax deferred until the assets are withdrawn. Starting in 2002, if the assets are used for qualified higher education expenses, then the earnings are exempt from federal income tax.<sup>1</sup> This means that if the expenses qualify, the investment income and gains will *never* be subject to federal taxation. Qualified expenses include tuition, fees, supplies, certain room and board costs and books. A few states also exempt the income from state taxation (this is not an issue in Washington which has no state income tax) if the assets are used for qualified higher education expenses or offer deductions/tax credits for contributions to their plan.

A custodian for a Uniform Transfers/Gifts to Minors Act ( “UTMA” or “UGMA”) account can liquidate their current investments and transfer assets to these plans; however, donors should weigh the benefits of such a move against the tax cost of liquidating the investments. Unlike College Savings Accounts, UTMA/UGMA College Savings Accounts can not be transferred to other family members.

Education IRAs now provide tax benefits comparable with College Savings Plans with greater flexibility (they aren’t limited to collegiate education), but with lower contribution limits. Please refer to the chart that compares some of the features of these plans with other college savings techniques.

The following is a brief summary of the major advantages and disadvantages of College Savings Plans:

### Major Advantages

- Earnings are exempt from federal income taxes if they are used for qualified higher education expenses.
- Accounts are transferable to other family members of the beneficiary. This may be a significant advantage for some families.
- Virtually anyone can contribute to one of these accounts regardless of their income level.
- Donors can contribute \$200,000 or more to one of these plans in a single year (subject to the Plan’s donor limits). Gift tax rules still apply, though a special gift tax provision allows a donor to consolidate up to five years of gifts (i.e., \$55,000 per individual/\$110,000 per couple) in one year to each beneficiary through a special election made on the donor’s gift tax return.

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<sup>1</sup> If Congress does not amend the law, in 2011 income and investment gains will be taxed at the beneficiary’s tax rate when funds are withdrawn.

- The donor retains control over the assets even if the assets are not used for higher education expenses.

## Major Disadvantages

- Most states still tax the earnings from these plans when they are withdrawn to pay for qualified higher education expenses. The state income tax liability should be small since the earnings are taxed at the beneficiary tax rate, which is typically lower than that of the donor's.
- To receive state-specific tax benefits, state residents must use the College Savings Plan adopted by their state. For example, California's plan is managed by TIAA-CREF. If California eventually exempts income from these plans from California state taxation, the state will probably only exempt earnings from assets invested in its own plan, and may not provide the exemption for amounts earned in other state's College Savings Plans. Since Washington does not have a state income tax, state residents are not concerned with this negative.
- Donors are limited to the investment options that are available within the College Savings Plan that they choose. However, the options available from a multitude of state plans allow a wide choice of various options where state tax considerations do not dictate an in-state plan.
- Donors cannot move money between the investment options within the plan. For example, if a donor elects to place \$50,000 in the 100% equity option, then the assets must remain in the 100% equity option until they are withdrawn. This is a very significant drawback to these plans. However, at least one state has requested a Private Letter Ruling from the IRS requesting that participants be allowed to move money between investment options within the state's plan. If the IRS rules in favor of this request, other states will likely request a similar ruling. Until this restriction is dropped there are two ways around this investment restriction:
  - i. The new law allows donors to move money between state plans once a year on a tax-deferred basis. For example, if a California donor was not comfortable with the investment option that he or she selected, the donor could move money to New York's plan on a tax-deferred basis and select new investment options under the New York plan.
  - ii. Most plans have an age-based asset allocation investment option available that automatically moves their plan's assets to lower risk investments as the beneficiary moves closer to the date that they would attend college. For example, California's age-based option allocates 80% to equities for a 1-year old beneficiary and by age 17 the allocation to stocks is only 25%.
- If assets are not used to fund higher education expenses, then the earnings are subject to federal and state income tax and a 10% federal penalty upon withdrawal.

The bottom line is that College Savings plans are a very effective vehicle for individuals to set aside money for the post-secondary education of their children, grandchildren and other family members. Since tax deferral is the primary benefit of these accounts, the earlier you start contributing, the greater the tax benefits.

**College Savings Techniques**  
**Comparison of Key Features**  
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	<b>College Savings Plans (Section 529)</b>	<b>Education IRAs</b>	<b>Uniform Transfer or Gifts to Minors Act (UTMA or UGMA)</b>	<b>Accumulate in Parent's Name</b>
<b>General Operation</b>	Account grows tax deferred. Starting in 2002, if assets are used for qualified higher education expenses, earnings are exempt from federal taxes. States may tax earnings when withdrawn.	Account grows tax deferred. Starting in 2002, if assets are used for qualified elementary, secondary or higher education expenses, earnings are exempt from federal taxes. States may tax earnings when withdrawn.	Earnings are taxed at children's tax rates. Kiddie tax rules apply to children under age 14.	Earnings taxed at parent's rate.
<b>High income taxpayers eligible to use this option?</b>	Yes	No, phase-outs begin at: In 2002 - \$95,000 (single) \$190,000 (couple) (Based on modified adjusted gross income.)	Yes	Yes
<b>Gifts count toward to \$11,000 per donor annual gift exclusion?</b>	Yes, though a donor can give \$55,000 in one year and average the donation over five years through an election on their gift tax return.	Yes	Yes	N/A, amounts are kept in parent's name.
<b>Limit on how much can be placed in the account?</b>	Yes. Varies by state. Can be as much as \$200,000 or more per beneficiary.	Yes, \$2,000 per year in 2002 and beyond.	No limit	No limit
<b>Assets transferable to other family members of beneficiary?</b>	Yes	Yes	No	Yes
<b>Available through banks, brokerage firms and other financial institutions?</b>	No, each state has its own plan.	Yes	Yes	Yes
<b>Assets can be moved easily between investment options?</b>	No, assets generally must be moved to another 529 plan to move between investment options.	Yes	Yes	Yes
<p>Note: This chart has been created for the benefit of <a href="#">Frederic T. Kutscher Associates clients</a>. Since tax laws relating to college savings techniques are constantly changing, we recommend that you consult our firm prior to utilizing one or more of these strategies.</p>				

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