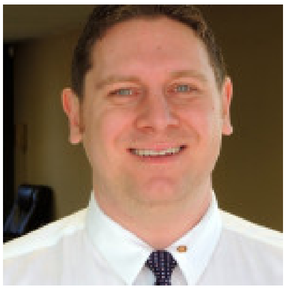
Money Matters: Education planning options

By Nic Abelow

This article provides an overview of the different tax-advantaged accounts available to help fund an education.

The cost of a college education continues to rise. The projected average total college costs for a child born in 2015 are nearly $550,000 for a four-year private college and $240,000 for a public college.1 If you are looking for tax-advantaged ways to get ahead of the curve, you have several choices – 529 plans, Coverdell Education Savings Accounts, and custodial accounts created under the Unified Gifts to Minors Act (UGMA) or Unified Transfers to Minors Act (UTMA) – but which ones may be right for you?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Generally, 529s, Coverdells, and UGMA/UTMA share the following characteristics:

· Earnings accumulate free from taxes.

· Qualified withdrawals are federally tax free. Nonqualified withdrawals may be subject to income taxes and a 10 percent additional federal tax.

· Contributions are treated as gifts for federal tax purposes (although contributions may be capped below the annual limits set by the IRS).

· Contributions are not deductible for federal income tax purposes (however, some states offer state tax credits or deductions).

Yet there are significant differences between the account types, including the definition of qualified expenses, contribution limits, income limits, ownership of the account, and other restrictions. Keep these in mind as we examine each option.

The lowdown on 529 plans

Named after the section of the federal tax code that governs them, 529 plans are generally sponsored by individual states or, in some cases, by qualified educational institutions. They are administered by investment companies, which also oversee the underlying assets.

There are two types of 529 plans. The more familiar one, the college savings plan, allows for the investment of contributions into portfolios of mutual funds or similar financial instruments. Most are national plans – that is, residents of one state may use a plan sponsored by another state.

Other key features of 529 college savings plans include:

· Generous lifetime contribution limits that often exceed $200,000 per beneficiary.

· Tax rules that let anyone give up to $14,000 in 2016, free from federal gift taxes, to as many individuals as they choose. Donors also have the option of averaging a single lump-sum contribution over five years, effectively allowing them to give up to $70,000 at one time, gift tax free.

· No income restrictions on contributors to a 529 plan.

· Money in a college savings plan may be used at any eligible college or university for qualified expenses such as tuition, books, and computer equipment.

· Qualified withdrawals may be exempt from state taxes as well (tax rules vary from state to state).

· The individual who creates a 529 plan account on behalf of a beneficiary generally maintains complete control over the account.

· Account owners may also change beneficiaries.

· Contributions to 529 plans may provide a state tax deduction for residents of the sponsoring state. If your state or your designated beneficiary’s state offers a 529 plan, you may want to consider what, if any, potential state income tax or other benefits it offers before investing.

The second type of 529 plan, called a prepaid tuition plan, lets you pay future tuition at today’s rates, essentially taking inflation out of the equation. These plans are, in general, available to residents of the sponsoring state for in-state tuition only, although some state schools offer them to out-of-state students, too, and some private schools offer them as well.

Coverdell: New name, better benefits

Coverdell Education Savings Accounts, known previously as Education IRAs, allow tax-free withdrawals for elementary and high school expenses in addition to college costs.

· Contributions are capped at $2,000 annually per beneficiary and are made with post-tax money. Excess contributions are subject to a 6 percent federal excise tax.

· Contributions are not deductible from income for federal tax purposes.

· The deadline to contribute to a Coverdell is generally April 15, the same deadline that applies to IRAs.

· Account owners may also change beneficiaries.

· You cannot contribute if your modified adjusted gross income is more than $110,000 if you file singly or more than $220,000 if you file jointly.

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· Assets must be used before the beneficiary’s 30th birthday.

UGMA/UTMA accounts

UGMA/UTMA custodial accounts are not college savings accounts, per se, but do offer gift tax and estate tax benefits to contributors as well as income tax benefits to the minors for whom they are established. Under the guidelines of UGMA or UTMA – nomenclature varies by state – adults may establish and contribute to a custodial account in a minor’s name without having to create a trust or name a legal guardian.

Other key features include:

· No limits on contributions.

· No withdrawal restrictions as long as the money is used for the benefit of the minor.

· Ownership of the assets by the minor, not the contributor.

· Investment earnings accumulate tax free for the contributor, but the minor may be subject to taxation at the kiddie tax rate.2

· Upon reaching adulthood, the child gains complete control of the UGMA/UTMA and is not required to spend the money on college.

Considerations

Choosing a college investment vehicle is not necessarily a "one or the other" decision – it may make sense for you to contribute to more than one type of account simultaneously. Speak with a financial and tax advisor about your particular needs.

Source/disclaimer:

1Source: ChartSource, DST Systems Inc. Estimates are based on average total costs (including tuition, fees, room and board, and other expenses). Projections are based on 2015-2016 costs of $47,831 for a four-year private college and $24,061 for a four-year public college, as reported by the College Board, and assume annual increases of 6 percent.

2During 2016, the first $1,050 is tax free, the next $1,050 is taxed at the child's rate, and any excess is taxed at the greater of the parents' rate or child's rate. Once the child reaches age 19, or 24 if a full-time student whose income does not exceed half of his or her annual support, all income is taxed at his or her rate.

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