



Smart Planning



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EDUCATION REPORT

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SAVING FOR HIGHER EDUCATION

The New Section 529 College Savings Plan

This Report is an update of our Volume 13 Issue 5 to reflect the changes brought by the Tax Relief Act of 2001 that apply in 2002. It provides an overview of the investment, tax, estate planning and other major considerations in choosing a higher education savings program. We hope that this article will be your core body of knowledge, your starting point before you begin to devise your own higher education program for your children, grandchildren, and other relatives.

On pages 2 and 3, there is a two-page table that gives you the major attributes for the most important college savings strategies or programs. In this article we have used some family situations to illustrate and explain the considerations that go into creating your personal plan.

Arne and Ingrid are grandparents with two grandkids, ages 3 and 6. However, their estate is over \$6,000,000, and they want to get some money out of their estate which will not be subject to estate taxes. They would like to put about \$50,000 into a college savings plan for each child. But they don't want to pay any gift tax on this transfer. They want the money to be well-managed, but they don't care about managing the investments themselves. Given the ages of the children, they think the money should be invested largely in stocks.

In 1996, the U.S. Congress adopted 26 USC 529, which authorized states to run college savings plans. One of these plans will meet all of Arne and Ingrid's goals. Although Washington State has not adopted a section 529



college savings plan, Arne and Ingrid can still enroll in a plan administered by another state since most state plans are open to residents of other states. The 529 plans will allow their grandchildren to go to any accredited university in the United States.

Under the 529 College Savings Plan, the \$11,000 annual gift tax exemption is loosened so that an individual can

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The information furnished in this newsletter about investments, tax provisions, and planning techniques is intended solely for your general information. This is a complex area with many ramifications not mentioned herein. You should consult your tax advisor and other professionals before making any decisions or taking any course of action mentioned herein.

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The Section 529 College Savings Plan was adopted by Congress and signed into law in 1996. In five years, it is rapidly becoming the favorite plan for many families because of the excellent income and estate tax benefits. This plan authorizes individual states to set up a college savings plan under the management of the state. The federal statute sets forth certain required parameters for the plan, and the states fill in the other attributes of the plan. The law authorized states to establish both a prepaid tuition and a savings plan. Over 30 states have now adopted Section 529 College Savings plans. Washington has only adopted a prepaid tuition program. But the college savings plans have a higher potential return than the prepaid tuition plans, which invest largely in low yielding municipal bonds. The prepayment amount is calculated based on the anticipated future yield of the municipal-bonds. You will be able to save much more for college if you invest part of your education monies in equity and equity mutual funds and obtain their historical average yield. However if stocks perform poorly for the next decade and college tuitions go up even faster than anyone is predicting the prepaid tuitions may actually turn out to be a better deal.

The early state plans followed a fixed age-weighted asset allocation. This meant that, as the child got older, the assets were shifted from equities into bonds to reduce the risk of loss of

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College Savings Programs - Taxation

Name of Program or Strategy	Contribution Limit per child	Annual Gift Tax Exemption	Subject to Estate Tax	Annual Taxation of Earnings	Income tax on money spent on education	Subject to GST tax
Section 2503 (c) Minor's Trust	None	11,000 per child per donor	In trustee donor's estate if retain to much discretion	Undistributed income & all cap gains on Trust tax return	None	No
Crummy Trust	None	11,000 per child per donor	In trustee donor's estate if retain to much discretion	Undistributed income & all cap gains on Trust tax return	None	Yes
Uniform Gift to Minors Account	None	11,000 per child per donor	In Donor's estate if is Custodian	On child's tax return, subject to kiddie tax	None	Yes
Section 529 Prepaid Tuition	Defined by plan	11,000 rule, but donor can prepay 4 yrs ¹	Part of Child's estate	Exempt if used for education	None	Yes
Section 529 College Savings	Lifetime limits vary, \$100k to \$170k	11,000 rule, but donor can prepay 4 yrs ¹	Part of Child's estate	Exempt if used for education	None	Yes
Direct Tuition Payments	None	Unlimited	In Donor's estate until payment	On Donor's tax return	None	No
Donor's Savings	None	11,000 per child per donor	In Donor's estate until payment	On Donor's tax return	None	Yes
Education IRA	\$2000 A Year ²	11,000 per child per donor	Part of Child's estate	Exempt ⁹	None	Yes

1. If donor dies prepaid years are included in their estate
2. Child must be under age 18
3. Tuition, fees, books, supplies, & equipment
Some room & board paid for at least 1/2 time students
4. Earnings taxed at donor's ordinary income tax rates
5. It may be possible to extend this age with child's consent
6. A private college may attribute money to child
7. Annual gift tax exemption applies
8. Earnings taxed at student's ordinary income tax rates
9. They are still subject to the alternative minimum tax
10. You can switch plans once a year.

not counted as part of the child's assets in calculations for financial aid eligibility in public universities and private schools receiving certain federal financial aid. Under the EFC formula adopted by the federal government 35% of the student's assets and 5% of the parents assets are counted in financial aid eligibility calculations.

More details about the 529 Plans are set forth in the companion article dedicated to those plans which starts on page 1.

Bjorn and Kirstin are in their late

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combine up to five years of \$11,000 exemptions in a single year. This means that both Arne and Ingrid could each contribute \$55,000 per child into a 529 Plan. However, they can't claim a \$11,000 annual gift exemption for that child in the follow-

ing four years. In addition the Generation Skipping Transfer tax (GST) does not apply to 529 plans unless a beneficiary is changed from a child to a grandchild.

Another added benefit of the 529 Plan is that the money in the plan is

College Savings Programs - Operation

Allowed Education Expenses	Can Donor Withdraw the money	Can money be switched to other child	Donor picks and manages Investments	Can change brokers or managers	Unspent \$\$ go to child at age	Owner for financial aid purposes	Name of Program or Strategy
Depends on Trust	No	Yes if Trust allows	Yes	Yes	21 ⁵	Child	Section 2503c Minor's Trust
Depends on Trust	No	Yes if Trust allows	Yes	Yes	Set by Trust	Child	Crummey Trust
Must benefit minor child	No	No	Yes	Yes	21 in WA	Child	Uniform Gift to Minors Account
Most college Expenses ³	Yes with 10% Penalty ⁴	Yes	No	Yes ¹⁰	Depends on state plan	Donor ⁶	Section 529 Prepaid Tuition
Most college Expenses ³	Yes with 10% Penalty ⁴	Yes	No	Yes ¹⁰	Depends on state plan	Donor ⁶	Section 529 College Savings
Tuition only	Yes	Yes	Yes	Yes	No Limit	Donor	Direct Tuition Payments
Donor's choose	Yes	Yes	Yes	Yes	No Limit	Donor	Donor's Savings
Most college Expenses ³	Yes with 10% Penalty ⁸	Yes	Yes	Yes	30	Child	Education IRA

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thirties and have two children, ages 10 and 13. The parents want both children to go to college and graduate school. Their estate is already over three million dollars and growing rapidly, and they want to start getting money out of this estate. They would like to take advantage of the \$11,000-per-person exemption and start gifting \$11,000 a year to each of the children for educational purposes. Their investment advisor has done well for them over the years in stocks and stock mutual funds, and they want to keep him involved in managing their college saving plan.

The 529 Plan does not work for them because the manager of each state plan selects the specific investments inside that plan. For them, an irrevocable child's trust based on Section 2503(c) of the Internal Revenue Code will meet most of their goals. They can be the trustee. However, it must be carefully drafted so that the trustee does not have too much discretion or this will place the assets back into their estate if they die. The trust can allow them to invest in a wide variety of prudent investments. They can also select the investment advisor or broker of their choice.

The trust could be divided into a

separate sub-trust for each child, or it could be a single pot trust. The trust could allow them to switch money from one child to another based on their educational needs. It will be an irrevocable trust, and the money will be out of their estate for estate tax purposes. The income and capital gains of their investments will be taxed to the trust. However, a trust's ordinary income tax brackets climb very quickly. As the trust assets increase and the income increases, they could also set up accounts for their children under the Uniform Transfers to Minors Act (UTMA) for this state. Each year they can review the tax brack-

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ets of the trust and their children, and decide whether income should be kept in the trust and taxed there or distributed to a child's UTMA account, and be taxed there. If the children are 14 or over, it will be taxed on their tax returns. If they're under 14, it will be subject to the kiddie tax, where investment income over \$1,400 is taxed at the parents' tax rates.

One of the big disadvantages of a 2503(c) trust is that under federal law the child must have a right to withdraw the money when he or she turns 21. Some attorneys have drafted trusts allowing a 30-day window after the child reaches age 21. During that time the child can elect to withdraw the money. If the child does not take the money, it will stay in trust to be used for the rest of their undergraduate and graduate studies. Obviously, the parents fervently hope that little Mario will not decide to grab the remaining money and buy a red racing Corvette. This technique has not been tested in the courts, so its current status must be reviewed at the time you decide to create the trust.

They could also create a trust called a Crummy Trust after the family that won the first court case allowing them. This case said that a 30 day withdrawal right is a sufficient "present interest" to qualify contributions to the trust for the \$11,000 annual gift tax exemption. This means that each year you make a contribution the future students have a right to demand it be taken back out of the trust and put in a UTMA account for their benefit. Under the 2503(c) Trust the kids get just one shot at it when they reach 21 and have been maturing for 3 years of college. With the Crummy Trust your teens get a shot

at it every year you contribute. If they do leave it in the trust you can set a withdrawal age beyond 21 that will insure funding for graduate school, post doctorates and even their residency.

"... the parents fervently hope that little Mario will not decide to grab the remaining money [at age 21] and buy a red racing Corvette."

The Uniform Gift to Minors Act and the later Uniform Transfer to Minors Act are uniform laws, which were drafted by the Commission on Uniform State Laws. All of the states have adopted some version of those laws. They are a simple standardized statutory trust whereby the custodian (as trustee) manages the child's assets until the child reaches the age of majority. In Washington, it's 21, but in some states, like New York, it's only 18. When the child hits that magical age, all of the assets in the trust must be immediately distributed to them. The custodian has wide discretion regarding the spending of the trust assets so long as they are spent for the "benefit of the child".

Bjorn and Kirstin's trust will be custom-drafted for them by an estate-planning attorney. Within the parameters allowed by law, they will be able to put the requirements and controls in the trust that they desire.

Jon (pronounced Yon) and Erica have three children between the ages of 8 and 12. Their assets are under \$700,000, but they expect their income to increase dramatically since Erica recently got her master's degree in computer science. They

would like to put about \$3,000 a year away for college for each child. They're not too concerned now about keeping the money out of their estate for estate-planning purposes. But they don't want the annual income to be taxed to their tax brackets, which will be increasing.

They also want to keep things very simple. They don't want to spend the money setting up a customized trust. Finally, they want to keep control over the investments and select an advisor to help create and implement an investment plan. They want a plan that will go beyond age 21, because they hope that one or more of the children will go on to graduate school.

What appears to work best for them is a combination of an Education IRA and a UTMA account. They can contribute \$2000 a year for each child to the Education IRA until the child reaches age 18. The money in the Education IRA will be exempt from all taxes when it is spent on educational purposes. The income and capital gains during the time it is in this IRA will also be tax exempt. They can't withdraw money from a UTMA account, but they could withdraw it from an Education IRA. The beneficiary must pay taxes on the accumulated earnings, plus a 10% penalty. The parents can act as custodians under both accounts and manage and direct the investments. They can't combine the tax breaks noted on page 6 with an Education IRA for the same expenses.

One of the special advantages of the Education IRA is that it does not have to be distributed until age 30. Therefore, they could switch the investments in the UTMA into income-oriented investments as the kids get closer to college, and use that money to pay for the first three years of college. Hopefully, they would exhaust

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The New Section 529 College Savings Plans

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the UTMA before the children reach age 21. Then, for the fourth year of college and on to graduate school, they would use the money from the Education IRA. Thus, it would be invested longer in stocks and equity mutual funds.

Under both the UTMA and the Education IRA, the asset will be considered an asset of the child for purposes of financial aid calculations. They're not too worried about this because they don't anticipate that the child will have a very large amount of assets.

If Jon or Erica acts as custodian of the UTMA, it will be considered part of their estate if they should die before those funds are spent on education. If they become concerned about this as their estate grows, they could ask a grandparent or friend to be a substitute custodian. The assets will then be considered part of the child's estate.

There is another option that none of the families we described have elected to follow. However it is still used by many parents and grandparents in this country. It's the one known as "Donor Savings". Under this plan, the parents or grandparents set aside some money in one of their brokerage or bank accounts for college savings and add to it when they can. The money is considered part of their estate for estate tax purposes, and the annual income and capital gains show up on their tax return. There are no special tax benefits or other restrictions dictated by statute. They have 100% control over the investments, and the brokers & advisors managing those investments. Clearly the negative tax impact will be substantial for people in high income tax

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principal as the child got closer to college age. Later plans are showing more variety. Some plans have a fixed asset allocation which continues all the way through the college savings period. Several states have adopted plans where the donor chooses the asset allocation between stocks and bonds. Some states have several different plans and you can allocate assets between the plans. Most plans allow you to change the child who is the beneficiary if one of the kids decides to lead kayaking expeditions in Alaska rather than sitting in a lecture hall somewhere.

The lifetime contribution limits set by the states range from \$100,000 to \$170,000 per child. Tuition, fees, books, equipment, supplies, are allowed educational expenses. Reasonable room and board at each college for at least half time students are also allowed. The plans are designed to be long term. But the statute allows you to switch from one state plan to another once a year. It's not clear if you could switch between two different investment plans run by the same state.

Some states allow the donor to amend the plan and make another person the plan owner or "participant". If the state has no restrictions on that, you may be able to make the child the plan owner. This means that he could withdraw money at his tax bracket if its not used for allowed educational expenses. Otherwise it will be taxed at the donor's tax rate upon withdrawal if it's not spent for education. Both will be subject to a 10% penalty.

The annual fees vary substantially for 529 plans from about 0.3% a year to 1.9% a year. Make sure this is one of the criteria on your shopping list.

The major features of the 529 college Savings Plans are:

- Money is not a donor asset for estate tax purposes
- Donor can contribute up to \$55,000 per child in one year to get the plan started
- The money withdrawn for education is not taxed
- Donor & child don't have to be a resident to participate in a state's plan
- You can spend the money at any accredited university in the U.S.
- There are no donor income limits
- Plans cover tuition, fees, books, supplies, equipment, and some room and board

You can contribute to a 529 plan and fund an Education IRA in the same tax year.

The big disadvantage of the 529 college savings plan, of course, is that the investment results are totally out of your control. They're in the hands of the investment managers hired by the state to manage the money contributed to their plan. Your child's future education is in their hands. However, some of the leading no load fund families have entered the fray as managers for various states. Fidelity, and TIAA CREF manage multiple state plans. Strong and American Century also manage state plans. The manager of one state's plans use the Vanguard funds extensively. So you have some good choices for managers for your family's 529 savings program. □

College Tax Savings Devices

Tax Benefit	Description	Qualifying Expenses	Maximum	Student	Course load
Hope Scholarship Credit	Tax credit for first 2 years of college ¹	Tuition, academic fees	\$1500 year per student	You, spouse & dependent	half time or more
Lifetime Learning Credit	Tax credit = to 20% of eligible expenses	Tuition, academic fees	\$1000 year per taxpayer	You, spouse & dependent	No limits
Loan Interest Deduction	Interest paid during first 5 years of student loan.	Tuition, fees, books room, & board	\$2000 in 2000 \$2500 in 2001	You, spouse & dependent	half time or more
US Govt. EE Savings Bond Interest ²	Exempt from federal & state income taxes	Tuition, academic fees	None	You, spouse & dependent	No limits
Employer Education Assistance Plan	Tax free \$ to employee Deductible by employer	Tuition, fees, books room, & board	\$5250 a year	Employee	No limits
Income Tax Deduction	Deduct from income	Tuition, academic fees	\$3000 a year	You, spouse & dependent	half time or more

1. Or other qualified post secondary education

There are several specific tax benefits that are available for assisting with the cost of higher education. The table above describes the tax benefits and some of their main features. Note the key difference between the Hope and the Lifetime Learning Credit. The Hope Credit is only good for two years of college, while the Lifetime Credit is available each year for a lifetime. The Hope Credit is calculated per student, while the Lifetime Credit is calculated on a per-family basis. You can't use both credits for the same expenses - you must choose one. Tax credits reduce your tax bill on a dollar-for-dollar basis. They are much more beneficial than deductions like the interest-paid deduction.

Using the credits is tricky. You need to work with your accountant very carefully in planning for the years that you want to use them to make sure you obtain the maximum benefit from the credit. For example, the first two years of college normally occur in three calendar years, but you can only take the credit in two of those three calendar years. Therefore, your accountant may want you to carefully

delay and prepay expenses in order to get the maximum use of the credit. You can't claim either of the credits for expenses you pay with a distribution from an Education IRA or a Section 529 plan.

The interest earned on US Government Series EE bonds purchased after 1989 is exempt from income taxation if the money is spent for qualified educational expenses. The exemption is prorated if only part of the proceeds are spent for education. They can not be put in the child's name. To obtain the college tax exemption, the bond owner must have turned 24 before the bonds were issued.

The Tax Relief Act of 2001 added a deduction for qualified educational expenses up to \$3,000 a year. This is deducted from gross income on page 1 of Form 1040. Congress also continued the Employer Education Assistance program through 2002.

You can't combine two of these listed tax benefits for any expenses, or apply them to money from an education IRA or a 529 plan. All of the tax breaks have income limitations. The table below shows the income limitations for married couples and single persons. If you can't contribute to an education IRA because of these limits try to find a grandparent who can. □

INCOME LIMITS & PHASE OUT RANGE

Name of Benefit	Married - Joint Filing	Head of Household or Single
Hope Scholarship Credit & Lifetime Learning Credit	80,000-100,000	40,000-50,000
Loan Interest Deduction	100,000-130,000	50,000-65,000
US Govt. EE Savings Bond Interest Exempt	81,100 - 111,100	54,100 - 69,100
Education IRA	190,000 - 220,000	95,000 -110,000
Tax Deduction	130,000	65,000

The Things You Should Not Do



Sometimes unwitting buyers have been sold insurance-type products for educational purposes. A common one is a **Variable Annuity**. After-tax dollars are contributed to the annuity, and earnings are tax-deferred until they are withdrawn. The money taken out is taxed at the owners ordinary income rate, not the lower capital gains rate. Money withdrawn from the annuity when the owner is under 59½ years old is also subject to a 10% federal tax penalty. If the annuity has not been held for at least seven years, you will also owe a surrender charge.

Most annuities are sold with a built in sales charge, death benefit, management fee, and admin. expense charge. This means that the annual fees are usually high, ranging between 2 and 2½%. The table below compares an investment into a taxable account with a common variable annuity for a family in the 36% tax bracket. They contribute \$10,000 a year for five years, continue saving for another five years, and then withdraw the money over four years of college. Each year they earn an 11% growth of capital plus a 1% dividend. The table shows their return after adjusting for 2.5% a year inflation.

The person with a taxable account held the money in equities without active trading, and paid a simple 20% capital gains tax on the money as it was withdrawn. You can see that they were able to withdraw \$27,167 a year compared to \$19,841 in the annuity.

If the annuity buyer did not have to withdraw the money until after they turned 59 1/2 and the annuity had a lower 2% annual fee the numbers are still unfavorable. Annuity 2 in the table returned \$22,183, a net of \$5,000 a year less than the taxable account.

The **Roth IRA** is also being sold as a device to help parents pay for their children’s college. The law says that earnings on a Roth IRA escape the 10% early withdrawal penalty if they are used to pay for certain college expenses. However, you have to read the fine print. The withdrawals of Roth IRA earnings are subject to ordinary income tax in the year that they are withdrawn. You escape this only if you’ve held the account for five years and you’re over 59½. This means younger parents will be taxed at their ordinary income rate.

The only time the Roth would beat a taxable account of younger parents is if the taxable account is trading so furiously that they are constantly being taxed on the gains. A long-term buy-and-hold procedure will normally win in the taxable account because of the difference between a 20% capital gains tax rate and the higher ordinary income tax rate.

However the Roth looks better for grand parents who want to help. By meeting the 5 year hold and 59 1/2 rules they can take all of the money out tax free. They could even make the grandchildren the IRA beneficiaries when they die so it will be out of their estate. With the Roth they do not have to start mandatory withdraws at age 70 1/2. But the Roth has such great long term estate planning value they may not want to use it for this purpose.

Do not choose a 529 Plan with **High Annual Fees**. The annual administrative / management fees. presently range from .31% a year to 1.86% a year. Assume a \$10,000 investment earns 11% before fees. The table below shows the results of compounding at three different annual fees. The family in the plan with a .31% annual fee earned a total of \$45,880 after 15 years while the family in the 1.86% plan only gained \$37,132.

Fee Rate		10 yrs	15 yrs
.31	10.69%	\$27,611	\$45,880
1.05	9.95%	\$25,819	\$41,488
1.86	9.14%	\$23,979	\$37,132

You may encounter someone selling their firm’s 529 Plan or Education IRA. This may not be the best plan for your situation. Do not fall into the trap of **Buying a Product**. Your far better off getting professional help in creating your unique college savings plan. A good planner can help you design the best course of action, and if you go the 529 route, help select the best state plan for you. A good college savings plan will consider the family’s income and estate tax issues, the investment strategy, the legal restriction of the various alternatives, and the role the donor’s want to play in this all important task. Finally it must meet the needs of the ultimate beneficiary—the child. □

	Taxable	Annuity	Annuity
Tax on Withdrawal	20%	46%	36%
Tax on Dividends	36%	0%	0%
Total Annual Fee	0.2%	2.3%	2%
Pre Tax Annual Withdrawal	\$31,267	\$27,854	\$28,657
After Tax Annual Withdrawal	\$27,167	\$19,841	\$22,183
Total Saved After Taxes	\$108,668	\$79,364	\$88,732

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and estate tax brackets.

The Direct Tuition Payment strategy is not well known to most people. The US tax laws allow a donor to make an unlimited amount of tuition payments for the benefit of the child without being limited to the \$11,000 annual gift tax exemption, or the GST. Another advantage of Direct Tuition Payments and the Donor Savings is that none of these assets belong to the child for purposes of calculating financial aid.

Look at the table on pages 2 and 3, and compare the features of the various plans and programs. Use this to make up your own checklist of the things you want in a college savings plan. All of the items in the table have some common elements that

are not indicated in the table. For example, all use after-tax dollars. None of them has an income tax deduction for the contribution into the plan. In all of the plans, parents, legal guardians, grandparents, and even family friends can be the donors. Each plan or strategy has different fees and costs associated with it. Make a list of the fees and costs related to your chosen plan. Excellent information about the various college savings strategies can be found on the Fidelity website. Go to:
[Http://www.fidelity.com](http://www.fidelity.com). □

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OUR TAX LAWS ARE CONSTANTLY CHANGING. CONSULT YOUR TAX ADVISOR BEFORE MAKING A TAX RELATED DECISION OR TAKING ANY ACTION.

The information furnished in this newsletter about investments, tax provisions, and planning techniques is intended solely for your general information. This is a complex area with many ramifications not mentioned herein. You should consult your tax advisor and other professionals before making any decisions or taking any course of action mentioned herein.

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