Education Dreams Can Come True with Proper Planning

Few people question the value of a college education, but the cost of sending just one child to college for four years can be staggering. With the cost of higher education rising faster than inflation, parents of today's five-year-olds may face college bills of more than $200,000.

HIGHER EDUCATION PREPARATION

To make the dream of putting your children or grandchildren through college a reality, you need to have a plan for how you will save and a sensible investment strategy. Your child's college tuition could be one of the largest expenditures you ever make. And, if you have more than one child, the financial commitment is even greater. The financial challenge you face is shared by millions of others. Even if your goal seems overwhelming now, proper planning and saving can put the cost of any college within your reach.

Logically, the more money you save, the better your chances of meeting your education goals. In addition, to get the greatest benefit from the power of compounded returns, you must start saving as far in advance as possible.

There are a number of factors to consider before embarking on your college savings program and a range of investment options to sort through. The decision to hold the investment in your child's name or your name is significant because the method you choose can affect who controls the account, your child's eligibility for college financial aid, and the amount of taxes you will pay.

Investing in Your Name – Investing in your own name gives you maximum control over your college savings program assets. You decide when (if ever) your child gets access to the assets. There is a price for this control — you pay taxes on the earnings in the account at your marginal income tax rate.

Investing in Your Child's Name – Savings in your child's or grandchild's name may seem appealing because earnings are taxed at the child's (presumably lower) tax rate. However, tax provisions limit the appeal of this strategy. First, tax law prohibits taking a personal exemption for anyone who can be claimed as a dependent on someone else's return. For example, if you claim your daughter on your return, she cannot also claim herself on her own return. Second, the standard deduction on unearned income for an individual claimed as a dependent is $1,050. Your child must pay taxes on any unearned income in excess of $1,050.

"Kiddie Tax" Rules – The "kiddie tax" rules can further limit the appeal of investing in your child's name. Any unearned income in excess of $2,100 for a child under age 19 (or if a full-time student, under age 24), is taxed at the higher of his or her rate or the parent's top marginal tax rate.

Taxation of earnings can be deferred or eliminated completely by using certain tax-advantaged college savings plans like 529 plans and Coverdell Education Savings Accounts (ESAs). How you structure your education fund can be as critical as how much you save. Your Benjamin F. Edwards financial consultant can help you examine these alternatives to decide which funding vehicle is best for you.

529 COLLEGE SAVINGS PLANS

A 529 College Savings Plan is an education savings plan sponsored by a state that is designed to help families set aside funds for future college costs. It is named after Section 529 of the Internal Revenue Code which created these types of savings plans in 1996. Each state determines the maximum amount you may contribute per child and the investments available. These plans are not all created equal. Keep in mind most states let non-residents participate in their plans; however, if you invest in your state's plan, you may also enjoy state tax benefits that may include a state tax deduction on contributions as well as state-tax-free withdrawals. Earnings in 529 accounts can grow free from federal and state taxes, and withdrawals for a beneficiary's qualified higher-education expenses are free from federal tax. About half of the states sponsoring 529 plans offer tax deductions on contributions. If you withdraw money from a 529 college savings plan for purposes other than higher education, earnings will be subject to federal income tax and possibly a 10% federal tax penalty.

Generally, these are required for enrollment or attendance. These generally include tuition, fees, books, supplies, equipment, and in some circumstances, room and board (as determined by the school), or special needs services required by a special needs student.

There are no income or age limits, so 529 plans are available to people of all ages and income levels. You can open a 529 plan for anyone— your child, grandchild, niece, nephew, friend or even yourself. In most cases, multiple people can contribute to the same 529 plan account (i.e. parents, grandparents, aunts, uncles and family friends). The account owner, usually the contributor, remains in control of the 529 plan and can change beneficiaries at any time without penalty provided the new beneficiary is a member of the previous beneficiary's family.

The only limit placed on contributions to a 529 plan is a "lifetime limit" which is set by each state sponsoring a plan. This limit is meant to keep individuals from dramatically overfunding college savings beyond what is realistically needed. However, you should also be aware of gift tax rules which require you to file a gift tax return for gifts over $14,000 to anyone besides your spouse (married couples can gift up to $28,000 a year to the same individual).

There is a special provision for 529 plans that allows five years of accelerated gifts, so married couples can contribute up to $140,000 in one year per student without gift tax consequences; single tax payers can contribute up to $70,000 per student. Any additional gifts given to the student within the current and following four years would trigger gift tax consequences in the years the gifts are made, including additional contributions to the 529 plan.

COVERDELL EDUCATION SAVINGS ACCOUNTS (ESAS)

The Coverdell ESA (formerly known as an Education IRA) helps families save for education in much the same way a Roth IRA helps individuals save for retirement. The after-tax dollars deposited into an ESA have the opportunity to grow and be withdrawn tax free, as long as withdrawals are used to pay the beneficiary's qualified education expenses. ESAs can be used to save for any level of education — from elementary school through graduate school. Not everyone can fund an ESA. There are income limits that may exclude mid- to upper-income families.

ESAs allow eligible parents, family members, and students to contribute up to $2,000 per year (until the child turns age 18) toward qualified education expenses at any college, university, vocational, elementary, or secondary school. The beneficiary can only receive a total contribution of $2,000 in any given year, regardless of the number of contributors to that account. The $2,000 is considered an irrevocable gift (so it doesn't belong to you anymore and you cannot get it back once the contribution is made) and is a non-deductible contribution.

If there is a balance in the ESA when the beneficiary reaches age 30, it must be distributed within 30 days unless the student is a special needs student. At that point, earnings on the account will be taxable and subject to the additional 10% tax. The beneficiary may avoid these taxes by rolling over the full balance to a Coverdell ESA owned by a family member.

CUSTODIAL ACCOUNTS (UGMA, UTMA)

Prior to the existence of 529 plans, the Uniform Gifts for Minors Act (UGMA) and the Uniform Transfer to Minors Act (UTMA) — also referred to as custodial accounts — were commonly used to save for college and transfer wealth to children and grandchildren. With custodial accounts, you appoint a custodian (i.e. you or another adult) to manage the investments and make distributions for the benefit of the minor. Custodial accounts can be used, but are not required to be used, to pay for education; however, once you've transferred or donated assets into a custodial account, it is irrevocable. If the donor acts as the custodian, he or she must act for the child's benefit and not for himself or herself.

Once the child reaches the age specified by his or her state of residence, the custodian's supervisory powers end and the child has control over the account's assets. As a result, the child may choose not to use the money for college. The child recognizes income in the account. There may be other drawbacks, such as a "kiddie tax," (discussed above) where the account is taxed at your tax rate rather than the minor's tax rate. If you would rather maintain control of the assets yourself, consider investing in your own name or in a 529 plan rather than a custodial account.

QUALIFYING U.S. SAVINGS BONDS

Issued by the U.S. Treasury and backed by the U.S. government, Series EE and I saving bonds are another option in education planning. You may use any sort of U.S. Treasury bonds, notes, and T-bills to pay for college expenses. Generally, you must pay federal income tax on interest earned on U.S. savings bonds.

Only Series EE and Series I savings bonds can be used to pay for qualified postsecondary education costs without having to pay federal income tax on the interest that you earn on your investment. You can purchase as little as $25 or as much as $10,000 of each series (EE and I) each year. There are income requirements that may exclude upper-income families from realizing these benefits. A bond purchased in the name of your child or grandchild will not qualify for the interest exclusion.

When the bonds are purchased, the owner must be at least 18 years old on the first day of the month in which the bond(s) were bought. If the bond owner is a parent and the proceeds are used for their children, the bond is considered to be a parental asset. If the proceeds are used for the parent's education, the bond is a student asset. To qualify as an education savings bond, you must use the bonds for qualified education expenses for yourself, your spouse or a dependent for whom you claim an exemption on your federal tax return.

TRADITIONAL AND ROTH IRAS

Retirement assets such as traditional IRAs and Roth IRAs can be used to meet eligible educational expenses for certain family members and the withdrawal is considered a penalty-free distribution. However, unlike the Coverdell ESAs and 529 plans, you will pay income taxes on the taxable portion of the distribution from an IRA or Roth IRA. Using your retirement savings for college is certainly an option, but your long-term retirement goals may need to be adjusted if you start using retirement savings for education.

PLANNING YOUR INVESTMENT STRATEGY

When looking for ways to build your child's education funds, consider the following strategies:

Review the income and estate tax savings benefits of 529 college savings plans. If you are able to make substantial contributions toward your child's or grandchild's college expenses, your first choice may be to fund a 529 plan by taking advantage of the accelerated gifting ability. By using these benefits, you will be able to contribute substantial amounts to the 529 plan and potentially take advantage of federal income tax free distributions. However, keep in mind that, depending on the size of your gift, this may limit your ability to make nontaxable gifts to the beneficiary(ies) for a number of years. Your Benjamin F. Edwards & Co. financial consultant can explore the gift and estate tax consequences with you.

Determine whether you're eligible to contribute to a Coverdell ESA. If you're eligible, take advantage of the tax-deferred savings that Coverdell ESAs offer. Keep in mind, however, that the $2,000 per year annual contribution amount probably won't be enough to meet your college expense needs but may help with elementary or high school expenses. Note: you can contribute to both a 529 plan and a Coverdell ESA in the same year for the same beneficiary.

TALK TO YOUR FINANCIAL CONSULTANT

At Benjamin F. Edwards & Co., we want to develop and sustain client relationships built on trust, integrity, and mutual respect. Before you make an investment decision, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification needs and liquidity objectives with your financial consultant.

To learn more about the education planning options available to you, talk to your financial consultant today. ■

IMPORTANT DISCLOSURES

An investment in a 529 plan will fluctuate such that an investor's shares when redeemed may be worth more or less than the original investment. Investors should carefully consider a 529 plan's investment objectives, risks, charges and expenses before investing. This and other important information can be found in the 529 plan issuer's official statement, which should be read carefully before investing.

Benjamin F. Edwards & Co. is not a tax advisor. Please consult your accountant to discuss the tax implications of the products discussed in this report before investing.