Chapter 12

EDUCATION FUNDING

INTRODUCTION

The expense of educating children has become one of today’s greatest financial burdens facing parents because of the large and constantly escalating annual costs, the increasing number of years required for \undergraduates to earn a degree, and the graduate or professional school education required for many careers. Along with planning for retirement and the purchase of a home the question of how to pay for their children’s education may be one of the most expensive challenges that parents will ever face.

Although this chapter will focus on college education expenses, financial planners must also consider that many clients will provide secondary—and even primary—school education for their children at private institutions with costs at those schools approaching or perhaps even exceeding college tuition costs.

How much funding is actually needed will depend upon many factors including the family’s educational goals and the time remaining until the goals have to be met. Families often have some combination of the following goals:

1. To provide private school education at the elementary and secondary levels

2. To provide funding of all or a portion of the college costs of one or more children at private institutions

3. To provide all or a portion of the college costs of one or more children at public institutions

4. To provide funding for all or a portion of the other educational programs (e.g., graduate or professional school education) for one or more children

5. To provide an educational fund for grandchildren or others

As with other financial goals, parents must determine education funding goals for their children and set priorities. Many parents will not be able to achieve all their goals and must weigh potential tradeoffs among them. For instance, parents who send their children to private elementary and secondary schools are using resources they could be applying to a college education fund. However, if the private elementary and secondary schooling provides a child with a sufficiently advanced education, the child may qualify for the more elite and well-endowed private college institutions that typically have more financial resources for aid and scholarships. Consequently, resources spent on elementary and secondary school education may be an investment that pays off in lower absolute dollar expenditures for college education at what are considered the more prestigious and elite colleges or universities.

The balance of this chapter is divided into two major sections. Part I helps to answer the question of how much funding is necessary to cover the cost of education. Part II deals with the various tools and techniques available for funding educational expenses.

PART I: COMPUTING THE REQUIRED
EDUCATION FUNDING NEED

Estimating college education costs and funding requirements involves essentially four steps:

1. Estimating education costs in current dollars

2. Projecting future education costs in inflated dollars

3. Determining the required current lump-sum investment

4. Calculating the required periodic investment

Each of these steps is discussed in turn below followed by a simplified college cost worksheet.

Estimating Expenses

For more and more children, college is becoming a normal stop in the road to a career and adulthood. In 1980, approximately half of the nation’s high school graduates enrolled in college. In a report from the United States Department of Labor, over 65 percent of 2013 high school graduates enrolled in colleges or universities[[1]](#endnote-1).

College costs also continue to increase, albeit at a slightly slower pace than what was seen in the 1980-2000 time frame. If the average annual increase of college costs is 4%, the total expenses for one year at a 4-year private college would rise from an estimated average of about $35,000 for the 2012-2013 school year to about $52,000 in 10 years and $77,000 in 20 years.

Despite these trends, paying for a child’s college education may be more within reach than many people think. For one thing, tax legislation enacted over the past decade has included provisions intended to make college more affordable. Still, the costs of higher education can be expected to put a strain on the finances of most families, especially when more than one child is in college. Scholarships and financial aid may be insufficient or unavailable for many students. Also, the use of loans can stretch college financing for parents well beyond graduation day and saddle graduates with a heavy load of debt.

Understanding College Costs

What are parents paying for when their child attends college? There are several components to college costs, but for simplicity we will divide the components into three categories:

1. Tuition

2. Room and board

3. Everything else

Tuition costs vary widely, as Figure 10.1 shows.

**Figure 10.1**

|  |
| --- |
| AVERAGE UNDERGRADUATE TUITION, FEES, AND ROOM AND BOARD (R+B) |
|  |  |  |
|  |  | 2009-2010 |
| 2-Year Institution (no R+B) |  | $3,322 |
| 2-Year Institution (w/ R+B) |  | $9,574 |
| 4-Year Public Institution (no R+B) |  | $8,070 |
| 4-Year Public Institution (w/ R+B) |  | $17,474 |
| 4-Year Private Institution (w/ R+B) |  | $35,074 |
|  |  |  |
|  |  |  |
| Source: U.S. Department of Education, National Center for Education Statistics. Public institution costs are for in-state. Data is for 2012-2013 school year[[2]](#endnote-2) |
|  |

Private 4-year colleges and universities, which teach about 20 percent of students in the U.S., charge the highest tuition. Their estimated average tuition, fees, and room and board of about $35,000 for the 2012-2013 school year for 4-year private institutions is over twice the amount of the average tuition, fees, and room and board charged by 4-year public colleges and universities.

The wide disparity between tuition levels arises because, unlike their public counterparts, private institutions cannot rely on tax revenues for support. Note that many students may not be charged full tuition, especially the higher amounts listed by private schools, because colleges sometimes discount their published tuition as part of a financial aid offer.

Room and board expenses typically constitute the next highest costs after tuition and fees. As you would expect, these costs take up a greater portion of total college costs—about twice as much—for resident students than for commuters. Everything else (i.e., books and supplies, transportation, laundry money, football tickets, pizza, activity fees, and so forth) makes up the rest of the costs.

Is a College Education Worth the Cost?

One important question arises: Is the time, money, and effort of attending college worthwhile? When looked at strictly from an earnings point of view, the answer is a resounding yes (see Figure 10.2). United States Census data show that college graduates earn an average of 80% more than high school graduates—an income advantage that has increased significantly over the years.

**Figure 10.2**

|  |
| --- |
| HOW EDUCATION PAYS OFF (2009 Information) |
|  |
| **Level of education\*** | **MedianIncome** |
|  |  |
| No high school education | $21,635 |
| Not a high school graduate | $25,604 |
| **High school graduate** | **39,647** |
| Some college | 48,413 |
| Associate’s degree | 56,789 |
| Bachelor’s degree | 75,518 |
| Master’s degree | 91,660 |
| Doctorate degree | 120,873 |
| Professional degree | 123,874 |
| More years of school correlate with higher incomes, according to U.S. Census Bureau data. |
| \**Source*: U.S. Census Bureau, Current Population Survey, Table 692., “Money Income of Households – Distribution by Income Level and Selected Characteristics: 2009” (http://www.census.gov/compendia/statab/2012/tables/12s0692.pdf) |

The President’s Council of Economic Advisors also offers a rough estimate of the worth of a college degree. They have estimated that the return on an investment in a college education is between 11% and 13% a year for life.

Adjusting for Inflation

College costs have historically grown at rates approximately twice that of the normal inflation rate. Over the last ten years, consistent with the general inflation rate, the average increase in college costs has stayed relatively low.

 Figure 10.3

|  |
| --- |
| **Average Tuition and Fees and Room and Board in 2014 Dollars, 2004-05 to 2014-15** |
|   | **Tuition and Fees and Room and Board in 2014 Dollars** |
| Academic Year | Private Nonprofit Four-Year | One-Year % Change | Public Four-Year | One-Year % Change |
| 2004-05 | $34,549  | — | $14,310  | — |
| 2005-06 | $35,046  | 1.4% | $14,772  | 3.2% |
| 2006-07 | $35,705  | 1.9% | $15,029  | 1.7% |
| 2007-08 | $36,593  | 2.5% | $15,507  | 3.2% |
| 2008-09 | $36,610  | 0.0% | $15,567  | 0.4% |
| 2009-10 | $38,799  | 6.0% | $16,855  | 8.3% |
| 2010-11 | $39,850  | 2.7% | $17,680  | 4.9% |
| 2011-12 | $40,043  | 0.5% | $18,092  | 2.3% |
| 2012-13 | $41,022  | 2.4% | $18,528  | 2.4% |
| 2013-14 | $41,771  | 1.8% | $18,749  | 1.2% |
| 2014-15 | $42,419  | 1.6% | $18,943  | 1.0% |
| NOTE: Average tuition and fee prices reflect in-district charges for public two-year institutions and in-state charges for public four-year institutions. |
| SOURCES: The College Board, Annual Survey of Colleges; NCES, IPEDS data. |
| This table was prepared in October 2014. |

**Figure 10.4**

|  |
| --- |
| COLLEGE COSTS PROJECTEDYearly Tuition, Fees, Supplies, Room & Board |
|  | Assuming Increases of 5% Per Year |
| NAME OF INSTITUTION | LOCATION | 2009 | 2014 | 2019 | 2024 |
| Auburn University | Auburn, Ala. | 15,812 | 20,181 | 25,756 | 32,872 |
| Bowdoin College | Brunswick, Maine | 48,570 | 61,989 | 79,115 | 100,974 |
| Brigham Young University | Provo, Utah | 11,470 | 14,639 | 18,683 | 23,845 |
| Bucknell University | Lewisburg, Pa. | 48,380 | 61,747 | 78,806 | 100,579 |
| The Citadel | Charleston, S.C. | 20,420 | 26,062 | 33,262 | 42,452 |
| Colorado State University | Ft. Collins, Colo. | 15,461 | 19,733 | 25,184 | 32,142 |
| Columbia College | New York, N.Y. | 49,218 | 62,816 | 80,171 | 102,321 |
| Dartmouth College | Hanover, N.H. | 47,694 | 60,871 | 77,689 | 99,152 |
| De Paul University | Chicago, Ill. | 36,934 | 47,138 | 60,162 | 76,783 |
| Drake University | Des Moines, Iowa | 32,392 | 41,341 | 52,763 | 67,341 |
| Duke University | Durham, N.C. | 47,810 | 61,019 | 77,877 | 99,394 |
| Emory University | Atlanta, Ga. | 47,908 | 61,144 | 78,037 | 99,597 |
| Florida State University | Tallahassee, Fla. | 13,185 | 16,828 | 21,477 | 27,411 |
| George Washington Univ. | Washington, D.C. | 51,607 | 65,865 | 84,062 | 107,287 |
| Hamline University | St. Paul, Minn. | 37,264 | 47,559 | 60,699 | 77,469 |
| Harvard College | Cambridge, Mass. | 47,215 | 60,260 | 76,908 | 98,157 |
| Jackson State University | Jackson, Miss. | 10,514 | 13,419 | 17,126 | 21,858 |
| Kansas State University | Manhattan, Kans. | 12,678 | 16,181 | 20,651 | 26,357 |
| Loyola University Chicago | Chicago, Ill. | 44,195 | 56,405 | 71,989 | 91,878 |
| Marquette University | Milwaukee, Wis. | 37,862 | 48,323 | 61,673 | 78,712 |
| Michigan State University | E. Lansing, Mich. | 18,760 | 23,943 | 30,558 | 39,001 |
| Middlebury College | Middlebury, Vt. | 50,210 | 64,082 | 81,787 | 104,383 |
| Ohio State University | Columbus, Ohio | 16,752 | 21,380 | 27,287 | 34,826 |
| Oral Roberts University | Tulsa, Okla. | 25,996 | 33,178 | 42,345 | 54,044 |
| Purdue University | W. Lafayette, Ind. | 16,546 | 21,117 | 26,952 | 34,398 |
| Rutgers College | New Brunswick, N.J. | 21,504 | 27,445 | 35,028 | 44,705 |
| St. Lawrence University | Canton, N.Y. | 47,550 | 60,687 | 77,454 | 98,853 |
| Salem International Univ. | Salem, W.Va. | 21,360 | 27,261 | 34,793 | 44,406 |
| Seattle University | Seattle, Washington | 37,080 | 47,325 | 60,399 | 77,087 |
| Southern Methodist Univ. | Dallas, Tex. | 43,295 | 55,257 | 70,523 | 90,007 |
| Stanford University | Stanford, Calif. | 49,105 | 62,672 | 79,987 | 102,086 |
| Texas A & M University | College Sta., Tex. | 17,044 | 21,753 | 27,763 | 35,433 |
| Tulane University | New Orleans, La. | 49,094 | 62,658 | 79,969 | 102,063 |
| University of Arkansas | Fayetteville, Ark. | 13,822 | 17,641 | 22,515 | 28,735 |
| University of California | Berkley, Calif. | 24,694 | 31,516 | 40,224 | 51,337 |
| University of Louisville | Louisville, Ky. | 14,622 | 18,662 | 23,818 | 30,398 |
| University of New Mexico | Albuquerque, N.Mex. | 12,834 | 16,380 | 20,905 | 26,681 |
| University of Rhode Island | Kingston, R.I. | 18,310 | 23,369 | 29,825 | 38,065 |
| University of Virginia | Charlottesville, Va. | 18,349 | 23,418 | 29,889 | 38,146 |
| Vanderbilt University | Nashville, Tenn. | 50,241 | 64,122 | 81,837 | 104,447 |
| Yale University | New Haven, Conn. | 46,000 | 58,709 | 74,929 | 95,631 |
| Yeshiva University | New York, N.Y. | 41,974 | 53,571 | 68,371 | 87,261 |
| **Average Cost** |  | 31,708 | 40,468 | 51,649 | 65,918 |
| *Explanation of Table*. Costs for public schools assume the student is a resident of the state. Costs (i.e., tuition) for out-of-state students are generally substantially more then shown. Costs for supplies are included when available. Costs for transportation are not included. Since over the past decade college costs have more than kept pace with the rate of inflation, it seems highly likely that costs will continue to escalate in the years to come. In this regard, see the Consumer Price Index on page 330. Source of 2008-2009 college education costs: Author research of college internet sites during the month of November, 2008, supplemented by direct inquiry when required. |
| Source: Cady, 2009 Field Guide to Estate Planning, Business Planning, & Employee Benefits, page 112 (Cincinnati, OH: The National Underwriter Company, 2009). |

If costs do grow at the 7% annual rate that many financial advisers suggest using as a reasonably conservative, high-end inflation rate for planning purposes, future college costs will quickly grow to incredible numbers. As Figure 10.5 shows, the parents of a child born in 2009 who expect their child to start college in about the year 2028 should anticipate average total 4-year college education costs to range from about $227,000 as a resident student at a public 4-year college to over $512,000 as a resident student at a private 4-year college. Moreover, surveys indicate that most people are not saving enough for college and that they also tend to underestimate how much college will cost.

**Figure 10.5**

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If your clients can identify some particular college or university that they favor and to which they plan to send their children, up-to-date and accurate information about current and projected costs can be obtained by calling the placement director or financial aid officer of that school. Keep in mind, though, that in addition to tuition and room and board, students will also need funds for books, fees, clothes, and miscellaneous entertainment expenses and, if they are away from home, travel. Costs for books and lab fees in the sciences, for example, can run as high as $1,000 per semester.

**Figure 10.6**

|  |
| --- |
| SIMPLIFIED COLLEGE COST WORKSHEET |
| 1. Enter child's AGE \_\_\_\_\_\_\_\_\_\_ |
|    |
| 2. YEARS to College (18 - child's AGE) \_\_\_\_\_\_\_\_\_\_ |
|    |
| 3. Annual College COSTS (current dollars) \_\_\_\_\_\_\_\_\_\_ |
|    |
| 4. Assumed College INFLATION Rate (%) \_\_\_\_\_\_\_\_\_\_% |
|    |
| 5. College INFLATION FACTOR   |
|  (Factor from Compound Interest Table, Appendix D, for Years In Step 2 |
|  and INFLATION Rate in Step 4.) \_\_\_\_\_\_\_\_\_\_ |
|    |
| 6. Estimated FUTURE ANNUAL COSTS   |
|  (Step 3 x Step 5) \_\_\_\_\_\_\_\_\_\_ |
|   |
| 7. Estimated TOTAL Future Costs   |
|  (Step 6 x number of years of college) \_\_\_\_\_\_\_\_\_\_ |
|   |
| FUNDING REQUIREMENTS |
| 8. Assumed After-tax RATE OF RETURN (%) \_\_\_\_\_\_\_\_\_\_% |
|  |
| 9. Present Value of Future LUMP-SUM Factor   |
|  (Factor from Present Value Table, Appendix A, |
|  for YEARS in Step 2 and RATE OF RETURN in Step 8.) \_\_\_\_\_\_\_\_\_\_ |
|  |
| 10. Total LUMP-SUM INVESTMENT Currently Required   |
|  (Step 7 × Step 9) \_\_\_\_\_\_\_\_\_\_ |
|  |
| 11. AMOUNT ALREADY EARMARKED for Education \_\_\_\_\_\_\_\_\_\_ |
|   |
| 12. Additional LUMP-SUM Funding Required   |
|  (Step 10 - Step 11) \_\_\_\_\_\_\_\_\_\_ |
|    |
| 13. YEARS OF FUNDING \_\_\_\_\_\_\_\_\_\_ |
|    |
| 14. Present Value of an Annuity Due Factor   |
|  (Factor from Present Value of an Annuity Due Table, Appendix B, |
|  for YEARS in Step 13 and RATE OF RETURN in Step 8.) \_\_\_\_\_\_\_\_\_\_ |
|   |
| 15. ANNUAL TARGET AMOUNT to Invest   |
|  (Step 12 ÷ Step 14) \_\_\_\_\_\_\_\_\_\_ |
|   |
| 16. Approximate MONTHLY TARGET AMOUNT to Invest   |
|  (Step 15 ÷ 12) \_\_\_\_\_\_\_\_\_\_ |
|    |

Planners can estimate future college costs by using the formula for computing the future value of a lump-sum value:

FORMULA 1

FV = PV x (1 + I)n

Where FV is the Future Value (future costs) of one-year’s college education;

PV is the Present Value (current cost) of one-year’s college education;

I is the assumed inflation rate; and

n is the number of years until the payment must be made.

Most planners, however, prefer to use financial tables, financial calculators, or computer programs such as *The Financial and Estate Planner’s NumberCruncher* to perform this computation. The Future Value of a Lump Sum Table in Appendix D has the necessary factors to compute future education costs using the following formula:

FORMULA 2

FV = PV x FV factor

Where FV and PV are defined as above; and

FV is the factor from the Future Value of a Lump Sum Table of Appendix D for the selected values of I (the assumed inflation rate) and n (the number of years until the child begins college).

For example, assume that

1. The current annual costs (PV) for your client’s choice of college are $21,420 per year.

2. Your client’s child is now four years old (which means n = 14 years assuming the child will be age 18 when beginning college).

3. The assumed college cost inflation rate (I) is 7%.

The future value factor from the Table in Appendix D when I = 7% and n = 14 years is 2.5785. Applying Formula 2, the estimated first-year cost after adjustment for inflation is $55,231.

FV = $21,420 x 2.5785 = $55,231

For each successive year of college, the cost could be estimated in a similar manner using the FV factors from the table for n = 15, 16, 17, etc., until the end of the projected college term. In most cases, a suitable estimate of the total cost can be determined by multiplying the first-year cost by the number of years of college (generally four). In this case, the total estimated cost is $220,924 ($55,231 x 4) for four years of college.

Determining the Required
Current Lump-Sum Investment

According to a government survey, 70% of families with annual incomes of $30,000 or more are managing to set aside money for future college bills. But the median amount being set aside is obviously inadequate (i.e., $904 a year). As described above, assuming annual costs rise 7% per year from our assumed cost of $21,420, parents with a four year-old child in 2009 will confront college bills that could total over $220,000. To be ready to handle bills of that magnitude, the parents would have to set aside in 2009 a lump-sum investment of about $97,715 in an account earning 6% net after tax, or about $825 a month net after tax, every year until the child is age 18. Even if the parents could earn 10% net after tax on their money, they would still need a lump-sum investment of about $58,200 in 2009, or would have to save almost $600 a month until their child is age 18. (Examples of how to compute these amounts follow.) Few investments can provide such returns over such a long period of time—especially after taxes are considered. Those few investments that might provide such returns do so with significant risk to capital, and income may be lost. Clearly, many parents may find themselves grossly underfunded when it comes time to pay college bills for their children.

To estimate the current lump-sum investment required to fund future education expenses the following time value formula may be applied:

FORMULA 3

|  |  |
| --- | --- |
| PV = FV x | 1 |
| (1 + r)n |

Where FV is the total estimated future education cost as determined above;

PV is the present value (required investment) of the future costs;

r is the assumed after-tax rate of return; and

n is the number of years until the child begins college.

The critical assumption when determining the required current investment is r, the assumed after-tax rate of return. The after-tax rate of return depends both on the type of assets in which the funds will be invested and on the tax that will apply to the earnings on those assets. Later in this chapter, the tax aspects of various accumulation strategies are discussed. A reasonable conservative estimate of the long-term after-tax rate of return should be used when projecting accumulations. If more aggressive investments and/or tax-deferring strategies are contemplated, a higher effective after-tax rate may be reasonable.

The Present Value of a Lump Sum Table in Appendix A may be used with the following formula to derive the same result as Formula 3:

FORMULA 4

PV = FV x PV factor

Where PV and FV are defined as above, and

PV factor is the factor from the Present Value of a Lump Sum Table in Appendix A for the selected values of r (the assumed rate of return) and n (the number of years until the child begins college).

For example, assume that

1. the total future costs are calculated (from above) to be $220,924;

2. the child will begin college in 14 years; and

3. the assumed after-tax rate of return is 6%.

In this case the PV factor from the Present Value of a Lump Sum Table in Appendix A is 0.4423. Applying Formula 4, the estimated current lump-sum investment required to fund the child’s education is $97,715:

PV = $220,924 x 0.4423 = $97,715

If the parents have already earmarked assets for the child’s education, the current value of these assets should be subtracted from the present value amount derived using Formula 4, to determine their current deficit. For example, if in the case described above the parents have already earmarked $22,500 for their child’s education, their current deficit would be $75,215 ($97,715 – $22,500).

Determining the Required Periodic Investment

Most clients will not have sufficient assets to fully fund their children’s education without some additional periodic investing. The amount they must save each year (or each month) depends principally on how long they have to accumulate the necessary funds—the earlier they start their funding, the less they will have to save each period. The level of required periodic investment necessary to fund their current deficit is determined using the following time value formula:

FORMULA 5

|  |  |  |
| --- | --- | --- |
| Pmt = Current Deficit ÷  | 1 - (1 + r)-nf | x (1 + r) |
| r |

To compute the annual payments that are necessary to fund the deficit, use r, the assumed after-tax rate of return used when determining the current funding deficit (as described above), and nf, which equals the number of years over which the funding will take place.

To compute the monthly payments that would be required, divide the annual rate of return (r) by 12 to determine the monthly rate of return and multiply the number of years (nf) by 12 and use these values in Formula 5 for r and n, respectively.

*Note*: The rate of return (r) assumed when using Formula 5 must be equal to the rate of return used in Formula 3. However, the number of years for funding (nf) do not have to equal the number of years until the child begins college (n). For example, a client may wish to determine the amount required each year to fund the deficit in five years, even though the child will not begin college for 10 years. More commonly, clients will want to know how much they will have to invest each year until the child’s last year of school, which is typically three years longer than the number of years until the child begins college; however, this could result in underfunding because as principal is removed each year, the rate of return is received on an increasingly smaller amount. For purposes of the calculations below, the number of years for funding will equal the number of years until the child begins college.

The Present Value of an Annuity Due Table in Appendix B can be used with the following formula to compute the same result as in Formula 5:

FORMULA 6

Pmt = Current Deficit ÷ PVAD factor

Where Pmt is defined as above; and

PVAD factor is the Present Value of an Annuity Due factor from Table B for the selected values of r and nf.

For example, assume that

1. The current deficit is $75,215 (as determined above).

2. The number of years of annual funding (nf) is 14 years (until the child who is currently age four begins her first year of college at age 18).

3. The assumed after-tax annual rate of return (r) is 6%.

The PVAD factor from Appendix B when r equals 6% and nf equals 14 years is 9.8527. Therefore, the required annual funding is:

Pmt = $75,215 ÷ 9.8527 = $7,634

The required monthly funding can be approximated by dividing the required annual funding by 12. In the case presented, the client would need to invest about $636 per month at a 6% after-tax rate of return for the next 14 years to fully fund the current deficit in the estimated amount required for the child’s education.

Assuming that the rate of return on the assets already earmarked for the child’s education equals that assumed in Formula 6, the combined amounts will equal the FV amount in Formula 4.

Simplified College Cost Worksheet

For many clients, the Simplified College Cost Worksheet (Figure 10.6) will provide adequate estimates to get them started on a savings program to meet their college funding requirements. The Simplified College Cost Worksheet incorporates the four steps discussed above in one simple planning tool. In Figure 10.7, the numbers from the example above are illustrated.

In cases where clients must fund the education of several children, planning to smooth out the required funding schedule, so that the required payments are not too burdensome in any given year, involves additional complexity. However, a unified funding schedule can be devised in the following manner:

1. Using steps 1 through 10 of the Simplified College Cost Worksheet, determine the current required lump-sum investment for each child.

**Figure 10.7**

|  |
| --- |
| COMPLETED COLLEGE COST WORKSHEET |
| 1. Enter child's AGE 4 years |
|    |
| 2. YEARS to College (18 - child's AGE) 14 yrs. |
|    |
| 3. Annual College COSTS (current dollars) 21,420 |
|    |
| 4. Assumed College INFLATION Rate (%) 7%  |
|    |
| 5. College INFLATION FACTOR |
|  (Factor from Compound Interest Table, Appendix D, for |
|  Years in Step 2 and INFLATION Rate in Step 4.) 2.5785 |
|    |
| 6. Estimated TOTAL Future Cost |
|  (Step 3 x Step 5) 55,231 |
|  |
| 7. Estimated TOTAL Future Cost x 4 |
|  (Step 6 x number of years of college) $220,924 |
|    |
| FUNDING REQUIREMENTS |
| 8. Assumed After-tax RATE OF RETURN (%) 6% |
|    |
| 9. Present Value of Future LUMP-SUM Factor |
|  (Factor from Present Value Table, Appendix A, |
|  for YEARS in Step 2 and RATE OF RETURN in Step 8.) 0.4423 |
|    |
| 10. Total LUMP-SUM INVESTMENT Currently Required |
|  (Step 7 x Step 9) 97,715 |
|   |
| 11. AMOUNT ALREADY EARMARKED for Education $ 22,500 |
|  |
| 12. Additional LUMP-SUM Funding Required |
|  (Step 10 - Step 11) 75,215 |
|  |
| 13. YEARS OF FUNDING 14 |
|    |
| 14. Present Value of an Annuity Due Factor |
|  (Factor from Present Value of an Annuity Due Table, Appendix B, |
|  for YEARS in Step 13 and RATE OF RETURN in Step 8.) 9.8527 |
|    |
| 15. ANNUAL TARGET AMOUNT to Invest |
|  (Step ÷ Step 14) $ 7,634 |
|  |
| 16. Approximate MONTHLY TARGET AMOUNT to Invest |
|  (Step 15 ÷ 12) $ 636 |
|  |

2. Add together the amounts derived in step (1) for all children to find the aggregate current required lump-sum investment. Place this value in step 10 of the Simplified College Cost Worksheet.

3. Use the remaining steps in the Simplified College Cost Worksheet to derive a level funding schedule over the desired funding period.

For example, assume that your clients:

1. have an annual before-tax family income of $100,000;

2. have three children, ages 4, 6, and 10;

3. plan to fund 75% of the cost of their children’s education at a private institution whose current tuition, fees, and room and board are about $21,420 per year (your clients believe the children should assume responsibility for 25% of the cost of their schooling);

4. believe they can invest at about a 6% after-tax rate of return;

5. have $30,000 currently earmarked to pay for their children’s education;

6. estimate college costs will rise at 7% per year; and

7. want to fund their current deficit over the period until their youngest child begins his senior year in college.

Figure 10.8 shows the analysis for this case. Based on these assumptions, your clients would have to invest about $18,725 per year, or about $1,560 a month, for the next 14 years to pay 75% of their children’s estimated college expenses. The annual payment represents more than 18% of the family’s current before-tax income. As this example demonstrates, funding college education can be a substantial burden for most families, even for those with considerable incomes.

**Figure 10.8**

|  |
| --- |
| COLLEGE COST ANALYSIS ASSUMING 6 PERCENT RETURN |
|   | 4-yr. Old | 6-yr. Old | 10-yr. Old |
| 1. Enter child's AGE | 4 | 6 | 10 |
|  |  |  |  |
| 2. YEARS to College (18 - child's AGE) | 14 | 12 | 8  |
|  |  |  |  |
| 3. Annual College COSTS (current dollars) | 16,065\* | 16,065\* | 16,065\* |
|  |  |  |  |
| 4. Assumed College INFLATION Rate (%) | 7% | 7% | 7% |
|  |  |  |  |
| 5. College INFLATION FACTOR (Factor from Compound Interest Table, Appendix D, for Years in Step 2 and INFLATION Rate in Step 4.) | 2.5785 | 2.2522 | 1.7182 |
|  |  |  |  |
| 6. Estimated FUTURE ANNUAL COSTS (Step 3 x Step 5) | $41,424 | $36,182 | $27,603 |
|  |  |  |  |
| 7. Estimated TOTAL Future cost (Step 6 x number of years of college) | $165,696 | $144,728 | $110,412 |
|  |  |  |  |
| FUNDING REQUIREMENTS |
| 8. Assumed After-tax RATE OF RETURN (%) | 6% | 6% | 6% |
|  |  |  |  |
| 9. Present Value of Future LUMP-SUM Factor (Factor from present Value Table, Appendix A, for YEARS in Step 2 and RATE OF RETURN in Step 8.) | 0.4423 | 0.4970 | 0.6274 |
|   |   |   |  |
| 10. Total LUMP-SUM INVESTMENT Currently Required | $73,287 | $71,930 | $69,272 |
|  |  |  |  |
| 10a. SUM of Line 10, all columns |   | $214,489 |  |
|  |  |  |  |
| 11. AMOUNT ALREADY EARMARKED for Education |   | $30,000 |   |
|  |  |  |  |
| 12. Additional LUMP-SUM Funding Required (Step 10a - Step 11) |  | $184,489 |  |
|  |  |  |  |
| 13. YEARS OF FUNDING |   |  14\*\* |  |
|  |  |  |  |
| 14. Present Value of an Annuity Due Factor (Factor from Present Value of an Annuity Due Table, Appendix B, for YEARS in Step 13 and the RATE OF RETURN in Step 8.) |  | 9.8527 |  |
|  |  |  |  |
| 15. ANNUAL TARGET AMOUNT to Invest (Step 12 ÷ Step 14) |  | $18,725 |  |
|  |  |  |  |
| 16. Approximate MONTHLY TARGET AMOUNT to Invest (Step 15 ÷ 12) |  | $1,560 |  |
|  |  |  |  |
| \* 21,420 total current cost x 75 percent that parent plans to fund |
| \*\* Years until youngest child starts first year of college |

Clearly, if a family can raise its effective after-tax rate of return through the use of income-shifting, tax-reducing, and tax-deferring techniques, they can substantially reduce their required funding. For example, Figure 10.9 shows the analysis for the client described above assuming that the effective after-tax rate of return is raised to 8%. In this case, the required annual funding is $16,122 (monthly, $1,343), or about 14% less than that required when the after-tax rate of return is assumed to be 6%. The following sections of this chapter discuss various income-shifting, tax-reducing, and tax-deferring strategies and techniques that can help your clients increase their effective after-tax rate of return on their education funds.

**Figure 10.9**

|  |
| --- |
| COLLEGE COST ANALYSIS ASSUMING 8 PERCENT RETURN |
|   | 4-yr. Old | 6-yr. Old | 10-yr. Old |
| 1. Enter child's AGE | 4 | 6 | 10 |
|  |  |  |  |
| 2. YEARS to College (18 - child's AGE) | 14 | 12 | 8  |
|  |  |  |  |
| 3. Annual College COSTS (current dollars) | 16,065\* | 16,065\* | 16,065\* |
|  |  |  |  |
| 4. Assumed College INFLATION Rate (%) | 7% | 7% | 7% |
|  |  |  |  |
| 5. College INFLATION FACTOR (Factor from Compound Interest Table, Appendix D, for Years in Step 2 and INFLATION Rate in Step 4.) | 2.5785 | 2.2522 | 1.7182 |
|  |  |  |  |
| 6. Estimated FUTURE ANNUAL COSTS (Step 3 x Step 5) | $41,424 | $36,182 | $27,603 |
|  |  |  |  |
| 7. Estimated TOTAL Future cost (Step 6 x number of years of college) | $165,696 | $144,728 | $110,412 |
|  |  |  |  |
| FUNDING REQUIREMENTS |
| 8. Assumed After-tax RATE OF RETURN (%) | 8% | 8% | 8% |
|  |  |  |  |
| 9. Present Value of Future LUMP-SUM Factor (Factor from present Value Table, Appendix A, for YEARS in Step 2 and RATE OF RETURN in Step 8.) | 0.3405 | 0.3971 | 0.5403 |
|   |   |   |  |
| 10. Total LUMP-SUM INVESTMENT Currently Required(Step 7 x Step 9) | $56,419 | $57,471 | $59,656 |
|  |  |  |  |
| 10a. SUM of Line 10, all columns |   | $173,546 |  |
|  |  |  |  |
| 11. AMOUNT ALREADY EARMARKED for Education |   | $30,000 |   |
|  |  |  |  |
| 12. Additional LUMP-SUM Funding Required (Step 10a - Step 11) |  | $143,546 |  |
|  |  |  |  |
| 13. YEARS OF FUNDING |   |  14\*\* |  |
|  |  |  |  |
| 14. Present Value of an Annuity Due Factor (Factor from Present Value of an Annuity Due Table, Appendix B, for YEARS in Step 13 and the RATE OF RETURN in Step 8.) |  | 8.9038 |  |
|  |  |  |  |
| 15. ANNUAL TARGET AMOUNT to Invest (Step 12 ÷ Step 14) |  | $16,122 |  |
|  |  |  |  |
| 16. Approximate MONTHLY TARGET AMOUNT to Invest (Step 15 ÷ 12) |  | $1,343 |  |
|  |  |  |  |
| \* 21,420 total current cost x 75 percent that parent plans to fund |
| \*\* Years until youngest child starts first year of college |

PART II: TOOLS AND TECHNIQUES
FOR FUNDING EDUCATION EXPENSES

There are a number of methods for financing a child’s education:

1. On a pay-as-you go basis out of current assets and income

2. Through government tax incentives

3. Through scholarships and loans

4. Working your way through school

5. The parents engage in a systematic plan of early savings and investment

6. The parents give gifts to children set aside sufficiently early to compound over a long period of time

7. Through a combination of these techniques

Most parents will use some combination of these techniques.

Pay-As-You-Go

From a planning perspective, the least favorable methods for financing education expenses are: (1) using current assets and income on a pay-as-you-go system; and (2) depending on scholarships and loans. Financing an education out of current income or assets is the most expensive alternative because it takes the least advantage of the time value of money and the favorable tax treatment available for funds that might have been set aside for this purpose. In addition, this method places the greatest strain on current disposable income.

Government Provided Tax Credits
and Other College Financing Tax Incentives

 American Opportunity Tax Credit and Lifetime Learning
Credit for Higher Education Expenses

Some taxpayers will be able to take advantage of the American Opportunity Tax Credit and the Lifetime Learning Credit to offset some of their U.S. federal income tax liability. These credits are available to certain taxpayers that meet the requirements outlined in the Internal Revenue Code. See chapter 31 for a description of these credits.

*Withdrawals from IRAs for Educational Purposes*

An individual generally is not subject to income tax on amounts held in a traditional IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. Amounts withdrawn from a traditional IRA are includable in gross income, except to the extent of nondeductible contributions. In addition, a 10% additional early distribution penalty tax generally applies to distributions from IRAs made before age 59½, unless the distribution is made: (1) on account of death or disability; (2) in the form of annuity payments; (3) for medical expenses of the individual and his spouse and dependents that exceed 10% of adjusted gross income (AGI); or (4) for medical insurance of the individuals and his spouse and dependents, without regard to the 10% AGI floor, if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year.

An important exception to the 10% early distributions penalty tax is available for distributions from an IRA to the extent such distributions, other than those already excluded from the penalty, do not exceed the qualified higher education expenses of the taxpayer for the taxable year. For these purposes, qualified higher education expenses are those furnished to: (1) the taxpayer; (2) the taxpayer’s spouse; or (3) any child or grandchild of the taxpayer or the taxpayer’s spouse, at an eligible educational institution. A child includes a son, daughter, stepson, or stepdaughter, an adopted child and, in certain circumstances, a foster child. Qualified higher education expenses are reduced by any amount excludable from gross income relating to the redemption of a qualified United States savings bond and certain scholarships and veterans benefits.

*Note:* The amount of qualified higher deduction expenses for any taxable year is reduced by: (1) the amount of scholarships or fellowship grants excludable from gross income under IRC Section 117; (2) any other tax-free educational benefits received by the student during the taxable year, such as employer provided educational assistance excludable under IRC Section 127; and (3) any payment, other than a gift, bequest, devise, or inheritance within the meaning of IRC Section 102(a), that is excludable under any United States law.

*Coverdell Education Savings Accounts (ESAs)*

Coverdell Education Savings Accounts (ESAs) allow for tax-free savings for certain educational expenses. An ESA is a trust or custodial account created or organized in the United States exclusively for the purpose of paying the qualified education expenses (see below) of the designated beneficiary of the account. The account must be designated as an ESA when it is created, in order to be treated as such for tax purposes.[[3]](#endnote-3)

Taxpayers may deposit cash of up to $2,000 per year into an ESA for a child younger than 18. Anyone may contribute to the child’s ESA provided the total contributions, on behalf of a particular beneficiary, for a taxable year do not exceed the $2,000 limit.[[4]](#endnote-4) Any contribution to an ESA on behalf of a designated beneficiary is a completed gift. Therefore, the gift qualifies for the gift tax annual exclusion. An ESA may be considered an asset of the designated beneficiary (i.e., the child’s asset) under the financial aid formulas. As discussed more fully in the section covering the college financial aid formula, this could reduce the amount of financial aid the family receives.

Amounts deposited in the ESA grow tax-free until distributed. Once distributed, the child will not owe tax on the amount withdrawn from the account if the child’s “qualified education expenses” at an eligible educational institution for the year equal or exceed the amount of the withdrawal.

The $2,000 contribution limit is subject to phaseout provisions for taxpayers (i.e., contributors) with modified adjusted gross income (MAGI) in excess of specified limits. The phaseout range begins at $190,000 for joint filers and $95,000 for single filers. The contribution limit is reduced proportionately for MAGI over these amounts, and is effectively eliminated once a taxpayer’s MAGI reaches $220,000 for joint filers and $110,000 for single filers. Like IRAs, contributions to ESAs for a given year must be made by April 15 of the following year.

*Example*: T, a joint return filer, has MAGI of $195,000 in 2014. Therefore, T is $5,000 into the $30,000 phase out range. The maximum amount T may contribute to an ESA is $1,666.67 ($5,000 / $30,000 x $2,000 = $333.33 phase out). T must make the contribution by April 15, 2015.

**Planning Point:** The phaseout rules could prompt some taxpayers to indirectly fund an ESA by making a cash gift to a relative whose income is less than the threshold amount of the phaseout rules. The relative would then make the contribution into the ESA of the taxpayer’s child. While this may still be attempted, this method is subject to attack by the IRS. In fact, a 2000 Tax Court case (not related to ESAs) held in favor of the Service where there was a pre-arranged plan of gifts. Taxpayers should be cautious because there is a 6% annual excise tax applied to excess contributions to an ESA. If the phaseout rules are an issue, EGTRRA 2001 made it clear that the rules applied only to individuals. Therefore, interpreters of the law have taken this to mean that corporations and other entities could be contributors, regardless of their income levels.

Distributions from an ESA are not included in the gross income of the distributee to the extent of the beneficiary’s: (1) qualified higher education expenses; or (2) qualified elementary and secondary school expenses during the taxable year, together referred to as qualified education expenses. Qualified higher education expenses are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university, or certain vocational schools. In addition, reasonable costs for room and board are qualified expenses provided the student is taking at least one-half the normal load for the particular program. However, the amount cannot exceed the minimum amount included for room and board for such period in the cost of attendance, as defined in Section 472 of the Higher Education Act of 1965, 20 U.S.C. 1087II, as in effect on August 5, 1997, for the eligible educational institution for such period. For students who live in housing owned or operated by the eligible educational institution, the actual invoice amount charged for room and board will be includable in qualified higher education expenses if that is greater than the standard allowance.

Qualified elementary and secondary school expenses are defined as expenses for tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law. Also included in the definition is: (1) room and board, uniforms, transportation, and supplementary items or services, including extended day programs, required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (2) the purchase of any computer technology, equipment, or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is educational in nature.

If the qualified expenses of the beneficiary for the year are less than the total amount of the distribution from an ESA, then the qualified expenses are deemed to be paid from a pro rata share of both the principal and earnings components of the distribution. An otherwise taxable distribution may be rolled over within 60 days into another ESA for the benefit of the same beneficiary, or a member of the family, which means:

1. a spouse of the taxpayer;

2. a son or daughter of the taxpayer (or a descendant of either);

3. a stepson or stepdaughter of the taxpayer;

4. a brother, sister, stepbrother, or stepsister of the taxpayer;

5. the father or mother of the taxpayer (or an ancestor of either);

6. a stepfather or stepmother of the taxpayer;

7. a son or daughter of a brother or sister of the taxpayer;

8. a brother or sister of the father or mother of the taxpayer;

9. a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer;

10. any spouse of an individual named in (2) through (9); or

11. any first cousin of the taxpayer.

Rollovers of account balances may be made from an ESA benefiting one beneficiary to an ESA benefiting a different beneficiary, as well as re-designations of the named beneficiary, provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30. Any balance remaining in an ESA is deemed distributed within 30 days after the date that the beneficiary reaches age 30 or, if earlier, within 30 days of the date that the beneficiary dies. The age limitations with respect to rollovers and required distributions do not apply in the case of a special needs beneficiary. Thus, a deemed distribution of any balance in an ESA does not occur when a special needs beneficiary reaches age 30. Finally, the age 30 limitation does not apply in the case of a rollover contribution for the benefit of a special needs beneficiary or a change in beneficiaries to a special needs beneficiary.

Distributions from an ESA that are not offset by any qualified expenses are included in the distributee’s gross income to the extent of the earnings on the accumulated contributions. In other words, the distributions are taxed under IRC Section 72 in the same manner as distributions from traditional IRAs that include nondeductible contributions. The taxpayer recovers the nondeductible contributions in essentially a pro-rata fashion. To the extent a payment or distribution from an ESA is includable in gross income, the recipient is subject to an additional penalty tax of 10% of the amount that is so includable. This 10% additional penalty tax can be avoided in the following circumstances:

1. The payment or distribution is made to a beneficiary (or his estate) on or after the death of the designated beneficiary

2. The payment or distribution is attributable to the designated beneficiary’s being disabled

3. The payment or distribution is made on account of a scholarship, allowance, or payment described in IRC Section 25A(g)(2) received by the account holder to the extent the amount of the payment or distribution does not exceed the amount of the scholarship, allowance, or payment

4. The distribution of any excess contribution to an ESA made during the taxable year on behalf of a designated beneficiary, which is received on or before the day prescribed by law (including extensions of time) for filing the contributor’s return for that taxable year and is accompanied by the amount of net income attributable to the excess contribution. For these purposes, the net income attributable to the excess contribution is included in gross income for the taxable year in which such excess contribution was made. The additional 10% penalty does not apply to the distribution of a contribution if such distribution is made before the first day of the sixth month (i.e., June 1) of the taxable year following the taxable year in which the contribution was made.

**Planning Point:** A taxpayer may claim an American Opportunity or Lifetime Learning Credit for a taxable year and exclude from gross income amounts distributed (both the contributions and the earnings portions) from an ESA on behalf of the same student, so long as the distribution is not used for the same educational expenses for which a credit was claimed.

Contributions may be made to an ESA and a qualified tuition program (QTP also known as a 529 plan) in the same year for a designated beneficiary.

For estate tax purposes, the value in an ESA is generally not included in the gross estate of the donor or beneficiary. The exceptions are as follows:

* Amounts distributed on account of the death of the beneficiary are included in the gross estate of the designated beneficiary.
* If the donor made an election to treat certain excess contributions as made ratably over a 5-year period and dies before the close of such 5-year period, the gross estate of the donor includes the portion of such contributions properly allocable to periods after the date of death of the donor.

If the account holder’s surviving spouse or family member acquires such holder’s interest in an ESA by reason of being the designated beneficiary of such account at the death of the account holder, the ESA will be treated as if the spouse or family member were the account holder, provided the surviving spouse or family member has not yet attained age 30.

If anyone other than the account holder’s surviving spouse acquires such holder’s interest in an ESA, by reason of being the designated beneficiary of such account at the death of the account holder, it ceases being an ESA as of the date of death. If that is the case, an amount equal to the fair market value of the assets in the ESA on that date will be includable, if such person is not the estate of such holder, in the person’s gross income for the taxable year which includes the date of death; or if the person acquiring it is the estate of such holder, in the gross income for the last taxable year of the estate. An appropriate deduction is allowed for estate tax attributable to the ESA under IRC Section 691(c) for income in respect of a decedent, to any person other than the decedent or the decedent’s spouse, with respect to amounts included in gross income by the person.

Any balance remaining in an ESA at the end of the 30-day period following the designated beneficiary’s death will be deemed distributed.

An ESA will be tax-exempt in the event of a prohibited transaction, and any pledge of the account is treated as a distribution to the extent of the amount pledged. For these purposes, an individual for whose benefit an ESA is established and any contributor to the account are not considered engaged in a prohibited transaction with respect to any transaction concerning the account, which would otherwise be taxable, if IRC Section 503(d) applies with respect to the transaction.

*Exclusion for Employer Provided Educational Assistance*

An employee’s gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applies to both undergraduate and graduate-level courses. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee’s current job.[[5]](#endnote-5)

*Section 529 Plans*

Section 529 plans, as the name implies, are governed by IRC Section 529, which deals with qualified tuition programs (QTPs). For simplicity purposes, we will refer to these programs as 529 plans or QTPs.

A QTP is a program established and maintained by a state, state agency, or an eligible education institution. The basic thrust of the program is to permit persons to; (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, a prepaid tuition plan; or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account, a savings account plan. The terms and conditions of these programs vary from plan to plan.[[6]](#endnote-6) However, there are some standard federal income tax rules that apply to these programs.[[7]](#endnote-7)

There are two different types of 529 plans: (1) prepaid tuition plans; and (2) college savings plans or savings account plans. With a prepaid tuition plan, the account owner (e.g., a parent) contributes cash to a plan account for a beneficiary, and the contribution purchases tuition credits (i.e., credit hours) based on then-current tuition rates. The account owner’s contribution qualifies for the gift tax annual exclusion. When the beneficiary attends a college participating in the program, the beneficiary’s tuition credits may be used to pay for all or a portion of the beneficiary’s tuition and certain other college expenses, regardless of tuition rates at that time. If the beneficiary does not go to college, or goes to a nonparticipating college, the tuition credits will be refunded in cash, based on a set formula or index, which may then be used to pay tuition and other college expenses at a nonparticipating college.

Generally, any difference between: (1) the value of the tuition and other expenses covered by the plan; and (2) the total amount of the account owner’s contributions to the plan is recovered tax-free.

With a college account plan, the account owner contributes cash to a plan account for a beneficiary, and the contribution is invested according to the terms of the plan. The account owner’s contribution qualifies for the gift tax annual exclusion. When the beneficiary attends virtually any college, the funds in the account (i.e., the account owner’s contributions plus all of the investment earnings thereon) may be used to pay for the beneficiary’s tuition and certain other college expenses.

A specified individual must generally be designated as the beneficiary at the commencement of participation in a 529 plan (i.e., when contributions are first made to purchase an interest in such a program) unless interests in such a program are purchased by a state or local government or a tax-exempt IRC Section 501(c)(3) charity as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

QTPs are themselves exempt from income tax. Cash distributions from QTPs are excluded from gross income to the extent that the distribution is used to pay for qualified higher education expenses as reduced by any in-kind distributions. This exclusion from gross income also applies to distributions from QTPs established and maintained by an entity other than a state, or agency or instrumentality thereof.

The funds in the plan can be used for tuition, fees, books, and supplies needed for higher education Room and board are also eligible expenses for such plans for beneficiaries who are at least half-time students. If the funds are not used for such expenses, the beneficiary will be taxed on the excess of the funds received over the amounts contributed.

For room and board expenses, QTPs may be used up to a specified level, generally the school’s posted room and board charge.

QTPs may be used to pay expenses not only at public and nonprofit institutions but also at proprietary schools (i.e., any school that is an eligible educational institution for purposes of the American Opportunity or Lifetime Learning Credits).

Contributions by donors are eligible for the $14,000 (in 2015) gift tax annual exclusion, $28,000 for split gifts by married couples. Therefore, for transfer tax purposes, such contributions are treated as a completed gift to the beneficiary. If the contribution is larger than the amount of the gift tax annual exclusion, the donor may prorate the contribution to the QTP over five years for purposes of claiming the gift tax annual exclusion. This allows a contribution of up to five times the amount of the annual exclusion, up to $70,000 for an individual in 2015 and up to $140,000 for split gifts, to be made without gift tax consequences. Note that the gift tax annual exclusion is indexed for inflation.

A QTP is controlled by the account owner, not the beneficiary. The account owner retains all the rights of ownership, including the right to name a new beneficiary, roll over assets from one plan to another, and receive distributions, albeit with possibly taxable results. Despite these facts, a QTP is generally not includable in the owner’s estate for estate tax or generation-skipping transfer tax purposes, even though the owner retains the same degree of control over a QTP that, with respect to any other transfer of property, would cause inclusion for estate tax purposes.

The limits on the amount of contributions imposed by plans vary. Some, however, have limits high enough to take advantage of the full amount allowed under the election.

*Example*: In 2015, John (age 70) wants to put $140,000 into a college savings plan for his granddaughter. By using the gift-splitting technique, allowing John and his wife, Mary, (age 65) a $28,000 annual exclusion, and by electing to prorate the gift over a 5-year period, John can transfer the entire $140,000 in 2015 without using any of his or his spouse’s unified credit or generation-skipping transfer tax exemption (i.e., there would be no gift tax or generation-skipping transfer tax consequences). If John dies during the next five years, his gross estate would include only that portion of the contributions allocable to periods after his death.

A 10% additional tax is imposed on any QTP earnings that are includable in taxable income because they are not used for qualified higher education expenses. Note that QTPs are not precluded from imposing their own penalties. However, it is anticipated that both states and educational institutions will welcome the administrative convenience, and would not receive sufficient revenues to warrant the competitive disadvantage they might suffer by imposing penalties.

The additional tax for nonqualifying distributions does not apply to distributions that are rolled over to a new QTP for the same beneficiary, or to a QTP for a new beneficiary who is a family member of the old beneficiary; nor does it apply to distributions made on account of: (1) the death or disability of the beneficiary; or (2) the beneficiary receiving a scholarship equal to or greater than the amount of the distribution.

A change in the designated beneficiary of an interest in a QTP is generally not treated as a distribution *if* the new beneficiary is a member of the family of the old beneficiary. Thus, in the above example, if John and Mary’s granddaughter decides not to go to college, they can change the beneficiary to their grandson without an adverse effect.

A transfer of credits (or other amounts) from an account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution unless the beneficiaries are members of the same family. For this purpose, the term member of the family is defined as:

1. a spouse of the beneficiary;

2. a son or daughter of the beneficiary, or a descendant of either;

3. a stepson or stepdaughter of the beneficiary;

4. a brother, sister, stepbrother, or stepsister of the beneficiary;

5. the father or mother of the beneficiary, or an ancestor of either;

6. a stepfather or stepmother of the beneficiary;

7. a son or daughter of a brother or sister of the beneficiary;

8. a brother or sister of the father or mother of the beneficiary;

9. a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary;

10. any spouse of an individual named in (2) through (9);

11. any first cousin of the beneficiary.

A transfer of credits, or other amounts from one QTP for the benefit of a designated beneficiary to another QTP for the benefit of the same beneficiary is not considered a distribution. However, this rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. This is intended to permit, for example, transfers between a prepaid tuition program and a savings program maintained by the same state, and between a state plan and a private prepaid tuition program.

One of the disadvantages of a QTP, at least in the eyes of some, is the prohibition against the owner or beneficiary from directing the investment of the contributions. Accordingly, choosing a QTP involves consideration of the program’s investment strategy. The addition of rollover provisions may permit dissatisfied investors to monitor account performances, and where appropriate, change to programs employing investment methods that are more effective.

Changes in many existing programs are bound to occur and one should never assume that any two or more plans are substantially identical in their terms or operation, or even that the terms of a plan are the same as they were previously. In this dynamic situation, individuals exploring their college funding options will require, in many cases, consultation with an attorney, accountant, or other financial advisor to assist in the review of all of the new particulars provided by a specific plan.

Many states have provided state tax advantages that mirrored to some extent the federal tax potential of tax deferral and the shifting of income to the presumptively lower tax bracket beneficiary. How states will treat educational institution sponsored trusts is not clear.

Taxpayers may claim an American Opportunity or Lifetime Learning Credit for a taxable year and exclude from gross income amounts distributed, both the principal and the earnings portions, from a QTP on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed—assuming that the other requirements for claiming the American Opportunity or Lifetime Learning Credit are satisfied and the modified AGI phase-out for those credits does not apply.

If, following a rollover or a change of beneficiary, the new beneficiary is in a generation lower than that of the old beneficiary, determined under the generation-assignment rules, the old beneficiary may be subject to gift tax on the amount rolled over, or, in the case of a change of beneficiary, on the entire QTP. If the new beneficiary is two or more generations lower than the old beneficiary, the old beneficiary may also be subject to a generation skipping transfer tax on such amount. In either case, the relevant amount should qualify for the gift tax annual exclusion and, if greater than the annual exclusion, such amount should be eligible for 5-year proration as discussed above, Any such amounts not thus covered by annual exclusions would either consume some of the gift and estate tax unified credit, and perhaps generation-skipping transfer tax exemption, or cause gift tax, and perhaps generation-skipping transfer tax, to be payable by the old beneficiary.

The Department of Education treats savings account plans as an asset of the owner for federal financial aid purposes. This is much more favorable than having the account treated as an asset of the beneficiary. Moreover, because the earnings portion of a distribution used for the beneficiary’s qualified higher education expenses is not generally included in the beneficiary’s income, it should not affect the beneficiary’s federal financial aid calculation in subsequent years.

Prepaid tuition plans are treated neither as an asset of the owner or the beneficiary, but are considered to reduce the beneficiary’s cost of attendance on a dollar-for-dollar basis, depending on the amount of tuition credits available to the beneficiary.

Grants, Scholarships, and Loans

Reliance on scholarships or special student loans is quite questionable, especially given the present financial aid trend away from outright grants and favorable loans. Even if favorable student loans are available, a client may not wish to saddle a child with large loans that must be paid off at a time when the child begins a career. Loans to parents are generally made at market interest rates and repayment commences shortly after the loans are taken out.

Most college aid packages include a combination of grants, loans, and work-study programs.

Federal Grants

Four federal grants are available: Pell Grants, Supplemental Educational Opportunity Grants (FSEOG), Academic Competitiveness Grants (ACG), and Nation Science and Mathematics Access to Retain Talent Grant (National Smart Grant). Unlike loans, grant recipients do not have to repay the grants unless, for example, the recipient is awarded funds incorrectly or withdraws from school.

**Pell Grants** are limited. The maximum award for the 2014-2015 award year was $5,730. Due to federal funding limits, the actual maximum grants may be less than this amount. Students who are eligible for Pell Grants receive the full amount they qualify for—each school participating in the program receives enough funds to pay the Pell amounts for all its eligible students. The amount of other student aid students might qualify for does not affect the amount of their Pell Grants.

**Supplemental Educational Opportunity Grants** **(FSEOGs)** range from a minimum of $100 to a maximum of $4,000 per year. Both the Pell and Supplemental federal grants are awarded only to academically promising students who also qualify under the financial needs formulas. Unlike Pell Grants, the FSEOG amounts received depend not only on their financial need, but also on the amount of other aid the students gets. Therefore, receiving other aid might reduce the amount of a student’s FSEOG award. In addition, not all schools participate in the FSEOG program and the funds available to those that do is limited. Each school participating in the FSEOG Program receives a certain amount of FSEOG funds each year from the United States Department of Education. When all of those funds have been disbursed for that award year, no more FSEOG awards can be made for that year. This is one reason why it is so important to apply early to be considered for these funds. Not everyone who qualifies for an FSEOG will necessarily get one.

**Teacher Education Assistance for College and Higher Education (TEACH) Grants** provide up to $4,000 per year to students who are completing or plan to complete course work needed to begin a career in teaching. As a condition for receiving a TEACH Grant, students must sign a TEACH Grant Agreement to Serve in which it is agreed that the student will teach:

* In a high-need field such as bilingual education, foreign language, mathematics, reading specialist, science and special education
* At an elementary school, secondary school, or educational service agency that serves students from low-income families
* For at least four complete academic years within eight years after completing the course of study for which the grant is received.

In the event that the service obligation is not completed, the TEACH Grant funds are converted into a Direct Unsubsidized Loan that must be repaid to the U.S. Department of Education with interest charged from the date the TEACH Grant was disbursed.

**Iraq and Afghanistan Service Grants** are available to individuals that are not eligible for a Federal Pell Grant on the basis of the Expected Family Contribution but otherwise meet the remaining Federal Pell Grant eligibility requirements and:

* The student’s parent or guardian was a member of the U.S. armed forces and died as a result of military service performed in Iraq or Afghanistan after the events of 9/11, and
* The student is under 24 years old or enrolled in college at least part-time at the time of the student’s parent or guardian’s death.

The grant award is equal to the amount of a maximum Federal Pell Grant for the award year but cannot exceed the cost of attendance for the award year. Adjustments to the maximum award amount for 2014-15 grants may be required due to sequestration.

Non-Federal Grants and Scholarships

Most states have programs similar to the Supplemental Educational Opportunity Grants program for students who are residents of and attend school within the state. These grants generally provide amounts less than $4,000 per year and are available only to students who demonstrate need.

Most colleges and universities also offer their own grants or scholarships. These funds are predominantly given to students who demonstrate financial need and superior academic potential. Many schools offer some scholarships to the most gifted students, regardless of need, but competition for these grants is especially intense.

Loans

Low interest federal loans are available and some high income families may qualify.

**Perkins Loans** (formerly called National Direct Student Loans) are awarded by colleges to undergraduate and graduate students on a first-come, first-served basis. The college decides whether the applicant needs the loan. Students from families with lower incomes are typically given preference, but gifted students with solid academic credentials may also qualify under this program. Depending on when a student applies, the level of need, and the funding level of the school, a student can borrow up to (1) $5,000 for each year of undergraduate study up to a total of $27,500, and (2) $8,000 for each year of graduate or professional study up to a total of $60,000, including any Federal Perkins Loans borrowed as an undergraduate. Interest is charged 5% and payments on these loans do not begin until after graduation. The loans are repaid over 10 years.

**William D. Ford Federal Direct Loans** are generally available to students who have financial need remaining after their Expected Family Contribution (EFC), Federal Pell Grant eligibility, and aid from other sources are subtracted from the cost of their attendance. The **Direct Subsidized Loan** is a direct government loan where. the government will pay the interest on the loan while the student is in school, for the first six months after the student leaves school, and when the student qualifies to have payments deferred.

Students who do not have financial need remaining may still utilize the Direct Unsubsidized Loan program for the amount of their EFC, or the annual Direct Loan borrowing limit for their grade level, whichever is less. Because an unsubsidized loan is not awarded on the basis of need, the Student’s EFC is not taken into account. In this case the loan is unsubsidized (i.e., interest is charged from the time the loan is disbursed until it is paid in full). However, the borrower may elect either to pay the interest as it accrues, or allow the interest to accumulate and be added to the principal amount of the loan. Students may receive a Direct Subsidized Loan and a Direct Unsubsidized Loan for the same enrollment period.

The maximum amounts students can be permitted to borrow under this program can vary year to year. The borrowing limits for the 2014-2015 academic year are discussed below.

Dependent undergraduate students can borrow up to the following amounts:

* $5,500 if they are first-year students enrolled in a program of study that is at least a full academic year; no more than $3,500 of this amount may be in subsidized loans
* $6,500 if they have completed their first year of study and the remainder of their program is at least a full academic year; no more than $4,500 of this amount may be in subsidized loans
* $7,500 a year if they have completed two years of study and the remainder of their program is at least a full academic year; no more than $5,500 of this amount may be in subsidized loans and
* $31,000 total until they graduate with no more than $23,000 of this amount being subsidized loans.

Independent undergraduate students, or dependent students whose parents are unable to get a PLUS Loan (i.e., a parental loan), can borrow up to the following amounts:

* $9,500 if they are first-year students enrolled in a program of study that is at least a full academic year; no more than $3,500 of this amount may be in subsidized loans
* $10,500 if they have completed their first year of study and the remainder of their program is at least a full academic year; no more than $4,500 of this amount may be in subsidized loans
* $12,500 a year if they have completed two years of study and the remainder of their program is at least a full academic year; no more than $5,500 of this amount may be in subsidized loans
* $57,000 total with no more than $23,000 of this amount being subsidized loans.

Graduate students can borrow up to $20,500 for each academic year, only $8,500 of which may consist of subsidized loans. In total, graduate students may borrow up to $138,500 with no more than $65,500 of this amount being in subsidized loans. This graduate student limit includes all federal loans received for undergraduate study.

The amounts described here are the maximum annual amounts students can borrow in both Direct Subsidized and Unsubsidized Loans, individually or in combination. Because students cannot borrow more than the cost of attendance minus the amount of any Pell Grant they are eligible for and/or any other financial aid they will get, the amount they actually receive may be less than the annual maximum amounts.

For undergraduates with Direct Subsidized and Unsubsidized Loans first disbursed on or after July 1, 2014 and before July 1, 2015, the interest rate is fixed at 4.66%. Graduate or Professional Education borrowers with a Direct Unsubsidized Loan are charged a rate of 6.21% for loans first disbursed on or after July 1, 2014 and before July 1, 2015.

Most states also have **subsidized state loan programs** similar to the federal loan programs. To qualify, students typically must (1) demonstrate need, (2) be a resident of the state, and (3) attend a state college or university.

**Parental Loans for Undergraduate Students (PLUS)** to meet students’ education costs are available through the Direct Loan program. Parents who have a good credit history can borrow a PLUS Loan to pay the education expenses of a child who is a dependent student enrolled at least half-time in an eligible program at an eligible school.

To be eligible to receive a PLUS Loan, parents generally will be required to pass a credit check. A parent cannot be turned down for having no credit history—only for having an adverse one. If parents do not pass the credit check, they might still be able to receive a loan if someone, such as a relative or friend who is able to pass the credit check, agrees to endorse the loan. An endorser promises to repay the loan if a student’s parents fail to do so. Parents might also qualify for a loan even if they do not pass the credit check as long as they can demonstrate that extenuating circumstances exist. The student and the parents must also meet other general eligibility requirements for federal student financial aid.

The annual limit on a PLUS Loan is equal to the student’s cost of attendance minus any other financial aid the student gets. If the cost of attendance is $10,000, for example, and a student receives $6,000 in other financial aid, the parents can borrow up to $4,000.

The student’s school will apply the money to the student’s tuition and fees, room and board, and other school charges. If any loan money remains, the parents will receive the amount as a check or in cash, unless they authorize that it be released to the student. Any remaining loan money must be used for education expenses.

For PLUS loans first disbursed on or after July 1, 2014 and before July 1, 2015, the interest rate is fixed at 7.21%. Interest is charged on the loan from the date the first disbursement is made until the loan is paid off. There is also a loan fee of 4.292% for PLUS loans disbursed on or after October 1, 2014 and before October 1, 2015. The loan fee is applied against the loan amount and is proportionately deducted from each loan disbursement.

Direct PLUS Loans enter repayment once the loan is fully disbursed. However, graduate or professional students will have the loan placed into deferment while they are enrolled at least half-time and for an additional six months thereafter. Parent barrowers may request a deferment while the parent or child are enrolled half-time and for an additional six months thereafter. Interest will continue to accrue on the loan during the period of deferment.

A Direct Loan or PLUS Loan *may* be canceled under any of the following conditions:

* The borrower dies (or the student on whose behalf a parent borrowed dies)
* The borrower becomes totally or permanently disabled
* The loan is discharged in bankruptcy
* The school closes before the student completes the program of study
* The school falsely certifies the loan

Even if a student does not complete the program of study at the school, does not like the school or the program of study, or does not obtain employment after completing the program of study, these loans must nonetheless be repaid. Neither type of loan (Direct or PLUS) can be canceled for these reasons.

Repayment assistance (i.e., not a cancellation, but another way to repay) may be available if a student serves in the military. For more information, contact a recruiting officer.

Most colleges and universities have their own loan funds as well. The qualifying criteria are generally similar to those used for loans, although most schools use the funds to help attract top students as well, regardless of the family’s financial need. Students who qualify as independents are rated for college aid without considering parents’ income or assets and, therefore, are much more likely to qualify for subsidized loans. However, qualifying for independent status is not an easy affair. (See Independent Student Status.)

If parents incur unexpected expenses or if their accumulated savings are less than anticipated, student loans combined with loans to parents may be good planning supplements. However, relying solely upon the future availability of loan programs as the centerpiece of a plan for financing education is risky. Careful consideration of alternative, or at least supplementary, planning vehicles will help insure a client’s ability to finance a child’s education.

Income Tax Deductions for Educational Expenses

Student Loan Interest Deduction[[8]](#endnote-8)

The deduction of student loan interest is permitted in certain circumstances. An individual who has paid interest on a qualified education loan may claim a deduction for such interest expenses under IRC Section 221. A qualified education loan is any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses that are incurred on behalf of the taxpayer, the taxpayer’s spouse or a dependent, as of the time the debt was incurred, that are paid or incurred within a reasonable period of time before or after the debt was incurred, and that are attributable to education furnished during a period during which the recipient was an eligible student. However, a debt owed to a related person cannot be a qualified education loan. In contrast, a refinancing of a qualified education loan is treated as a qualified education loan.

Qualified higher education expenses are the cost of attendance at an eligible education institution, reduced by the amount excluded under an educational assistance plan, qualified education bonds, or qualified tuition program distributions, and the amount of any scholarship, allowance, or payment excluded with respect to the American Opportunity and Lifetime Learning Credits. An eligible education institution is the same as for the American Opportunity and Lifetime Learning Credits, but the term also includes an institution conducting an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

An eligible student is defined the same as for the American Opportunity and Lifetime Learning credits above. In addition, the following requirements apply:

* The deduction is taken above-the-line in computing adjusted gross income (AGI).
* All student loan interest including voluntary payments are now potentially deductible, without limitation as to the length of time the payments are required. Under earlier law, the deduction was allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments were required.
* No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer’s return for the taxable year.

The amount of the deduction is limited in two ways:

* First, the amount allowable cannot exceed $2,500.
* Second, for 2015, the maximum amount otherwise allowable as a deduction is reduced by the maximum amount deductible, according to the limits above, multiplied by the ratio that the excess of the taxpayer’s Modified Adjusted Gross Income (MAGI) over $65,000 ($130,000 for married taxpayers filing jointly) bears to $15,000 ($30,000 for married taxpayers filing jointly). For these purposes, modified adjusted gross income is computed after applying the Social Security inclusion, moving expenses, and passive loss rules, but without regard to either the student loan interest deduction, the exclusion for amounts received in redemption of qualified education savings bonds, the exclusion for certain adoption expenses, the foreign earned income exclusion and foreign housing exclusion, and amounts excluded from certain United States possessions or Puerto Rico.
* The maximum deduction amount is not indexed for inflation; however the phaseout amounts listed above are indexed for inflation, rounded down to the next closest multiple of $5,000. As a result of this reduction based on MAGI, in 2015 for single taxpayers no deduction may be taken if MAGI exceeds $80,000 and the amount that may be deducted is reduced proportionately if MAGI is between $65,000 and $80,000. For married taxpayers filing a joint return in 2014, no deduction may be taken if MAGI exceeds $160,000, and the amount that may be deducted is reduced proportionately if MAGI is between $130,000 and $160,000. Married taxpayers filing separately may not take the deduction.

Certain eligible education institutions, or any person in a trade or business, or any governmental agency, that receives $600 or more in qualified education loan interest from an individual during a calendar year must provide an information report on such interest to the IRS and to the payer.

Given the limitations on deductibility, many parents may not qualify to deduct interest on educational loans or may not be able to deduct all of the interest they pay on such loans. One possible alternative is to use home equity loans to help finance college education expenses. Interest on home equity loans of up to $100,000 may be deductible regardless of how the proceeds are used. In many cases, this may be a more tax-effective and less costly means to finance college education expenses than various educational loan programs.

Tuition and Fees Deduction[[9]](#endnote-9)

Taxpayers may deduct up to $4,000 of college tuition and fees paid for them, their spouses, or any other persons claimed as a dependent on their returns. This is an above-the-line deduction, which means taxpayers do not have to itemize in order to take advantage of the break. However, the $4,000 amount is the annual maximum, regardless of how many students taxpayers may have in their families. The other ground rules are as follows:

* Taxpayers do not get the full deduction if they are unmarried with modified adjusted gross income above $65,000, or are joint filers with modified AGI above $130,000. However, if their modified AGI is between $65,001 and $80,000 for singles or between $130,001 and $160,000 for joint filers, they are entitled to a reduced deduction which allows them to deduct up to $2,000 of college tuition and fees.
* Taxpayers are completely ineligible if they are married and file separately from their spouses.
* Any taxpayer who can be claimed as a dependent on another taxpayer’s returns is ineligible for the deduction. Thus, taxpayers’ dependent college-age children cannot claim the deduction when the parents’ own AGI is too high to qualify.
* Taxpayers may not claim a deduction for expenses paid with earnings from a Section 529 plan or withdrawals from a Coverdell Education Savings Account. Also, taxpayers cannot claim the deduction in the same year they claim the American Opportunity or Lifetime Learning tax credit for the same student.
* Unless extended once again by an act of Congress, the Tuition and Fees Deduction expires after 2015.

Deduction for Employment Related Education Expenses

A deduction for certain education expenses is generally allowed under IRC Section 162 if the education or training: (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer; or (2) meets the express requirement of the taxpayer’s employer, or requirements of applicable law or regulations, imposed as a condition of continued employment. As a general rule, education expenses are not deductible if they relate to certain minimumeducational requirements or to education or training that enables a taxpayer to begin working in anew trade or business. In the case of an employee, education expenses, if not reimbursed by the employer, may be claimed as an itemized deduction only if such expenses relate to the employee’s current job, and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer’s adjusted gross income (AGI).

Cancellation of Certain Student Loans

In the case of an individual, gross income subject to federal income tax does not include any amount from the forgiveness, in whole or in part, of certain student loans, provided that the forgiveness is contingent on the student’s working for a certain period of time in certain professions for a broad class of employers.

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education and activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses, in contrast to tax free scholarships under IRC Section 117, which are limited to tuition and required fees. In addition, the loan must be made by: (1) the United States, or an instrumentality or agency thereof, (2) a state or any political subdivision thereof; (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law; or (4) an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the IRC Section 108(f) exclusion.

The exclusion is also available with respect to forgiveness of loans made by tax-exempt charitable organizations (e.g., educational organizations or private foundations) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. Again, the exclusion applies only if the forgiveness is contingent on the student’s working for a certain period of time in certain professions for any of a broad class of employers. In addition, in the case of loans made by tax-exempt charitable organizations, the student’s work must fulfill a public service requirement. The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

Federal Work Study Program

Parents are widely divided on whether children should help to pay for their college education by working during the school year. Some parents believe that their children will appreciate their college education more and apply themselves more diligently to their college studies if they have to work to pay for part of their education. Other parents are concerned that work during the school year may distract children from their studies and adversely affect their performance. Should the parents favor children working during the college months? Some studies indicate that students who work up to 20 hours per week during the school year perform no worse, and in some cases perform better, than their colleagues who do not work during the school year.

Students who decide that their financial situation requires them to work during the school year to make ends meet may qualify for the Federal Work-Study (FWS) Program. The FWS Program provides part-time jobs for undergraduate and graduate students with financial need, allowing them to earn money to help pay education expenses. The program encourages community service work and work related to the recipient’s course of study. FWS can help students get a foot in the door by allowing them to gain valuable experience in their chosen field before they leave school.

Students in the FWS Program are paid by the hour. No FWS student may be paid by commission or fee. The school must pay students directly at least once a month. Wages for the FWS program must equal at least the current federal minimum wage, but may be higher depending on the type of work the student does and the skills required. The total FWS award depends on when the student applies, financial need, and the funding level at the student’s school. The amount FWS students can earn cannot exceed their total FWS award. When assigning work hours, the employer or financial aid administrator will consider the award amount, the student’s class schedule, and the student’s academic progress.

The jobs available under the FWS program are usually provided by the student’s school or by private nonprofit organization or public agencies, and the work performed must be in the public interest. In some cases, a FWS student’s school may also have agreements with private for-profit employers for FWS jobs. This type of job must be relevant to the student’s course of study.

Parents are more likely to favor their children working during the summer months. The planner should advise the parents that the college aid formula used when awarding aid to students presumes that students will work during their summer vacations and will contribute that money to the payment of their college expenses.

Systematic Saving and Gifts

For most parents, careful and early planning is essential to financing their children’s education. Tax benefits can be used to increase the efficiency of long-term savings. In addition to the value of long-term compounding over time, the client may find that shifting the ownership of dollars saved to the child, or to an entity taxed at the child’s tax bracket, may increase the after-tax yield on the fund. The earlier the client implements a long-term savings plan, and the younger the child is at the time the savings program is undertaken, the longer the interest and dividends produced by the fund will be compounding. These factors in turn enhance the efficiency of the savings effort. Although tax law offers only minimal opportunities for income-shifting to lower tax bracket children, some very limited opportunities are available. For example, with the reduced rates (e.g., 0% in 2011 and 2012 – see Chapters 31-34) on most long-term capital gains for taxpayers in the 15% or 10% income tax brackets, gifts of appreciated property to children may result in tax savings. However, the potential application of the kiddie tax rules may eliminate or greatly reduce any potential savings. For details, see Taxation of Children and Gifts of Appreciated Assets of Minors later in this chapter.

The College Aid Formula

Unfortunately, shifting assets from a client to a child may have adverse consequences with respect to the child’s eligibility for financial aid. As will be discussed in more detail below, a standard formula is used for all applicants for financial aid to determine what is called the Expected Family Contribution (EFC). The federal formula approved by Congress to calculate the EFC is called the Federal Methodology (FM). The federal methodology is used to determine eligibility for federal funds. If a college or university relies on a different formula for awarding its own funds, that formula is called the Institutional Methodology (IM). Different colleges and universities may use different institutional methodologies.

The EFC is the sum of the expected student contribution (ESC) and the expected parental contribution (EPC):

EFC = ESC + EPC

The calculation of the expected student contribution may differ from school to school if they use the institutional methodology, but is generally 20% of the student’s assets and 50% of the student’s income above an income protection allowance 6,310 for the 2015-2016 academic year.

For example, a student who has $10,000 of income in 2014 and qualifying assets of $20,000 is applying for aid in the 2015-2016 academic year. According to the federal methodology, fifty percent of the student’s income of $3,690 (the amount in excess of the student’s adjustments (assuming zero), including a $6,310 income protection allowance), or $1,845, and $4,000 of the student’s assets (20% of $20,000), or $5,845 total, will be treated as available to pay college education expenses when computing the student’s aid package for the 2015-2016 academic year.

The federal methodology computes the expected parental contribution (EPC) in essentially the same way as the ESC with some addition adjustments to account for the number of parents with earned income, their income and assets, the age of the older parent, the family size, and the number of family members enrolled in post-secondary education. Income for this purpose includes not just the taxable income from the parents’ tax return, but also nontaxable income such as Social Security benefits and child support. Home equity is not included in calculating the expected family contribution (EFC) under the federal methodology, but many private schools and universities include the parents’ home equity when computing the aid formula using the institutional methodology as a way of rationing their school’s own grant and scholarship funds. Money set aside in retirement plans such as a 401(k), IRA, Keogh, or 403(b) is usually not counted as an asset. However, the funds contributed to a tax-deferred retirement program during the previous year must be included on the official financial aid form (FAFSA) as other untaxed income. In addition, an asset protection allowance shelters a portion of the assets from the calculation of the parental contribution. The asset protection allowance increases with the age of the parents to allow for emergencies and retirement needs.

Low-income families are most likely to qualify for aid, but even families with incomes in excess of $70,000 or even $100,000 may qualify, depending on circumstances. Do not arbitrarily assume children will not qualify for aid if a client’s income is substantial—a family’s income is only one factor in determining who receives aid. The parents’ real estate assets, investments, and savings (and, in some cases, home equity, if the college employs the institutional methodology) are all counted when determining the parents’ contribution.

The family financial burdens, such as medical bills, the size of the family, the number of children in private schools or colleges, and the years until the parents expect to retire may all reduce the required parental contribution amount. In addition, the larger is a student’s income and savings, the smaller is the aid award—all else being equal.

Planning Tips for Reducing the EFC

There are several consequences of the structure of the needs analysis formula that are worth noting.

If a child is unlikely to qualify for aid, the family may be able to successfully employ income-shifting techniques to help accumulate funds for education (see the following discussion regarding Taxation of Children). However, if a child would otherwise qualify for aid in the absence of income shifting and asset shifting to the child, employing income-shifting techniques may be counter-productive and parents would often do better accumulating funds themselves.

The obvious disincentives of the formulas for computing the expected family contribution put parents in a “Catch-22” position. Lower-income parents who are conscientious and thrifty may be less likely to receive aid than higher income, but more profligate parents. In addition, the assets and income of parents are taxed by the federal methodology need analysis formula at a much lower rate than those of the student. This means that it may not be to the advantage of the parties to shift income and assets to their children, despite potential income tax savings.

For example, parents who have managed to save $50,000 might be expected to contribute about $2,400 of it to help pay for a child’s college expenses when the college works out the aid package for the child. If these assets had been transferred to the child, in general, at least $10,000 (20%), or $7,600 more than if the parents owned the assets, would be used when computing the child’s aid award. Although a family’s financial status is equal in either case, the aid award from the college will be considerably smaller when the assets are owned by the child.

Generally, after application of the federal methodology aid formulas, the practical effect is that no more than about 5.6% of a parent’s assets—above an educational savings and asset allowance and excluding their home equity and retirement programs—are expected to be used for the child’s educational costs. For virtually all parents, the first $25,000 to $50,000 of their assets, depending on their age and family size, will be ignored completely, sheltered by the asset protection allowance, in the federal methodology needs analysis formula.

Since the student’s assets are taxed at a much higher rate than the parents’ assets, the family should spend down the student’s assets before using any of the parents’ assets to pay for the student’s education. Otherwise, the student’s assets will again be subject to the high tax rate during the next year’s needs analysis. Just because the formulas assumes that students contribute at least 20% of their assets and parents only about 5.6% does not mean that a client must treat those percentages as targets.

The federal aid methodology divides the parents’ contribution by the number of children in college to determine the parents’ contribution for each child. Changes in the number of family members in college can significantly affect the amount of aid received. For example, even families that are well off may become eligible for financial aid when two or more children are enrolled in college at the same time. So parents should not assume that they are ineligible for aid just because they earn a sizeable income.

The financial aid award or package for a given academic year is based on the assets and earnings for the calendar year before the academic year. For example, the financial aid award for the 2015-2016 academic year is based on the parents and student assets and earnings in 2014. So parents should be careful about their financial activity the year before their children enter college. For example, parents who avoid creating or recognizing capital gains during the child’s senior year in high school will be at an advantage in the federal methodology need analysis system.

If the parents’ income varies substantially from year to year, they should try to rearrange income fluctuations in their favor. For example, they should try to defer income from the base year for determining aid to the next year. Also, they should try to defer deductions from the year prior to the base year, or accelerate deductions from the year after the base year, to the base year.

Business property is not treated in the same manner as the primary residence, which is only considered, in some instances, when schools use the institutional methodology, not the federal methodology, or any other real estate holdings in the needs analysis. If part of the primary residence is used for business purposes, be sure to indicate it on the financial statement.

Consumer debt (e.g., car payments, credit card payments, payments on personal notes, and so on) is not counted in the federal methodology needs analysis formula, but may or may not count in part, for exceptional items, in the institutional methodology However, home equity loans do reduce the home equity reported in the needs analysis when colleges use the institutional methodology. Therefore, using home equity loans to replace other consumer debt will sometimes lower the family assets in the institutional needs analysis formula and increase the potential aid award.

Parents should consider making any large, planned purchases in cash to reduce liquid assets immediately before filling out the financial aid forms. For example, if your client has been planning on buying a new car or making home improvements, he should be advised to pay for it using up liquid assets (savings) prior to filling out the form. The decreased savings reduce the family asset value and, thus, the expected parental contribution.

Clients should maximize elective deferrals to company-sponsored savings plans such as 401(k) plans or tax-deferred annuity plans, for clients who are employees of non-profit institutions. These retirement assets do not count as available assets on the needs analysis forms.

Additionally, tax-deferred investments such as single-pay life, whole life, variable life, and universal life insurance and annuities do not count as available assets in the needs analysis formula. This makes these instruments especially attractive investment vehicles if one is trying to maximize the potential financial aid award.

Independent Student Status

As noted earlier, students who qualify as independents are rated for college aid without including their parent’s income or assets. This status may benefit some students who would otherwise not qualify to receive aid.

Students are considered independent if they meet any of the following criteria:

1. They will be 24 years old by December 31 of the award year, even if they are still living at home

2. They are orphans or wards of the state

3. They are armed forces veterans

4. They have legal dependents other than a spouse

5. They are graduate students or students at professional schools and will not be claimed as a dependent by their parents for the first calendar year of the award year

6. They are married and will not be claimed as a dependent by their parents for the first calendar year of the award year

The school may ask students who claim to be independent to submit proof before they can receive any federal student aid. Students who think they have unusual circumstances, other than one of those conditions listed above, that would qualify them as independent students may talk to their school’s aid administrator. Aid administrators can change a student’s status if they think a student’s circumstances warrant it based on the documentation provided. But remember, aid administrators will not automatically do this. The decisions are based on the aid administrators’ judgments, and they are final—students cannot appeal the aid administrators’ decisions to the U.S. Department of Education.

Income-Shifting Techniques

Before the reach of the kiddie tax was broadened to include 18-year olds and students under age 24, parents and their student/children could often optimize their education funding by shifting income and assets and accumulating funds in a tax-advantaged way. Under the expanded kiddie tax rules, most of these opportunities are now all but extinct.

Taxation of Children

A child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over $2,100 (for 2015) if that tax is higher than the tax the child would otherwise pay on it.[[10]](#endnote-10) The parents can instead elect to include on their own return the child's gross income in excess of $2,100 (for 2015).[[11]](#endnote-11)

A child is subject to the kiddie if:

(1) (a) he or she has not attained age 18 before the close of the tax year; or

 (b) he or she turned 18, or 19 to 23 if a full-time student, before the close of the tax year and has earned income for the tax year that does not exceed one-half of his or her support;

(2) either parent of the child is alive at the end of the tax year; and

(3) the child does not file a joint return for the tax year.[[12]](#endnote-12)

Because earned income is always taxed at the child's tax rates, one way of providing a child with income without triggering increased tax liability under the kiddie tax rules is to employ the child (at reasonable compensation) in, for example, a trade or business owned by the parent. Computer literate children, for example, could help with a variety of tasks. As a result, the child's earnings will not be subject to the kiddie tax and will generate a deduction for the family business, assuming the wages are reasonable for the work actually performed. As an added bonus, this could help to avoid the kiddie tax on unearned income of a child age 18 or age 19 through age 23 if a full-time student.

For purposes of the kiddie tax, support is defined the same as it is for the dependency deduction requirement that a qualifying child not provide more than one-half of his or her own support for the tax year. However, any scholarships received by a student for study at an educational organization[[13]](#endnote-13) are excluded in determining the total support paid for the student for the tax year.[[14]](#endnote-14)

Consequently, because of the changes, any planned transfers of income-generating stocks, bonds, and other investments to children age 18, or those age 19 to 23 who are full-time students, must be reconsidered or postponed to eliminate or decrease the child's unearned income.

Although the opportunity to lower taxes by transferring income-producing assets to children age 18, or children age 19-23 who are full-time students, is curtailed by the kiddie tax rules, investing a child's funds in investments that produce little or no current taxable income, can help avoid the kiddie tax. These investments include, for example, stocks and mutual funds oriented toward capital growth that produce little or no current income; vacant land expected to appreciate in value; stock in a closely-held family business that pays little or no cash dividends; tax-exempt municipal bonds and bond funds; and United States series EE savings bonds for which interest reporting may be deferred.

Investments that produce no taxable income, and that are therefore not subject to the kiddie tax, also include tax-advantaged savings vehicles, such as, traditional and Roth IRAs, which the child, or the parents acting for the benefit of the child, can establish or contribute to if the child has earned income; qualified tuition programs (529 plans); and Coverdell education savings accounts (ESAs).

Under the kiddie tax rules, a parent can elect (on Form 8814) to include in the parent's gross income for the tax year the child's gross income in excess of $2,100 (for 2015) if certain requirements are met. Doing so avoids the need to file a separate return for the child, and except where the child can claim certain deductions the electing parent cannot (see below), the tax on the child's income will generally be the same whether the parent elects to report the income or the child files a separate return. However, whenever parents make the election, they should consider that the addition of the child's income to the parents’ adjusted gross income (AGI) may affect the various floors and ceilings for, and thus the amount of, the parents’ deductions.

In addition, an electing parent cannot take certain deductions that the children could take on their own returns absent the parents’ election—for example, the children's itemized deductions such as the children's investment expenses or charitable contributions. Therefore, whenever a child can claim any of these deductions, the parents should evaluate whether they may save taxes overall if the child files a separate return.

Consideration should also be given to the fact that if the child’s income is included on the parents’ return, their AGI will increase which may cause the further limitation on personal exemptions, itemized deductions, the impact of the net investment income tax and other thresholds that are determined based on AGI.

For net investment income tax purposes, it should be noted that children that are otherwise subject to the kiddie tax have their own $200,000 MAGI threshold before their investment income is subject to this tax.

Taxation of Trusts

Trusts are generally required to use a calendar year for tax purposes; however, tax-exempt and charitable trusts are exceptions to this rule.

For tax years beginning in 2015, the indexed tax rate brackets for trusts are: 15% on the first $2,500 of taxable income; 25% on taxable income between $2,500 and $5,900; 28% on taxable income between $5,900 and $9,50; 33% on taxable income between $9,050 and $12,300; and 39.6% on taxable income over $12,300.[[15]](#endnote-15)

The net investment income tax applies to trusts and estates with MAGI in excess of the start of the 39.6% tax bracket ($12,300 for 2015).

The 2% floor on miscellaneous itemized deductions applies to trusts and estates as well as to individuals.

Quarterly payments of estimated tax are required of trusts in the same manner as they are of individual taxpayers.

The combination of the compressed trust tax rate schedule for undistributed trust income, the kiddie tax rules for distributions of trust income to children under the age of 19, or under age 24, if a full-time student, and the college aid formulas that apply a tax (contribution) rate on assets held by children at a minimum rate of 20% as compared to an effective average parental asset tax (contribution) rate of about 5.6% has essentially eliminated the opportunity for the effective use of trusts for income and asset shifting to children for college funding purposes. Parents may still use trusts effectively for other financial planning purposes or special cases, such as in the case of divorce, special needs for children, and the like, that may include funding for a child’s education among their other support objectives, but these are uses beyond the scope of this discussion of college education funding.

Taxation of Fellowships
and Scholarships

Scholarships and fellowship grants of degree candidates are excludable from gross income only to the extent spent on tuition and course-related expenses. Any portion of the money that pays for room and board and other non-education costs is taxable. Also, IRS rulings require scholarships that are awarded to students who have teaching, research, or other responsibilities associated with the grant to be allocated between the service portion and the scholarship portion. The portion of a grant or scholarship allocated to service is considered taxable income to the student. Non-degree candidates receive no exclusion.

Income-Shifting and
Parents’ Support Obligation

Advisers should not recommend the use of income shifting techniques to help fund a child’s education without some consideration of the tax impact such techniques may have as a result of a parent’s support obligations. As a general rule, if resources are used to satisfy the parent’s legal obligation to support a child, the parent, not the child, is subject to tax on the income. While the basic concept is easily understood, this issue has long been a subject with unknown boundaries. The principal question is whether or not a parent’s legal obligation to support a child includes the obligation to pay for a child’s college education.

The implication of the applicable case law is generally that in states where a college education is considered a normal support obligation of the parents, funds that parents have transferred to a child are the child’s money. Therefore, the child does not have to use those assets to pay college expenses even though the parents gave the child the money with the express purpose of having the child use it to fund the child’s college education! In other words, using non-parental funds to pay the normal support obligations of the parents, including paying college education expenses, in states that extend the support obligation to college education is a breach of a parents’ fiduciary duty. Such breaches could result in fines and penalties and would normally require that the parents make complete restitution. In addition, custodial funds used to pay college expenses would be taxable to the parents in a state where the parents have an obligation of support that extends to college education.

In general, the courts have considered a number of factors (e.g., the parents’ means, ability to pay, and station in life) in determining whether a college education is a normal support obligation. If, after assessing a client’s financial status, college financing needs, and their parental support obligation in their state, it appears that income and asset shifting may serve their purposes, advisers and parents should consider the tools and techniques that are still available in light of the expanded kiddie tax rules described in this chapter.

Gifts to Minors

The most direct method of giving funds to children is making gifts under the Uniform Gifts to Minors Act (UGMA) or under the Uniform Transfers to Minors Act (UTMA).

A gift to an UGMA or UTMA account (generally called a custodial account) usually qualifies for the gift tax annual exclusion. The gift is completed by opening an account and transferring property to a custodian for the benefit of the minor child. Specially drafted legal documents are usually not required. The types of assets that can be transferred to a custodial account are defined by state law. In some states, the asset categories are limited to money, securities, and insurance policies. Other states have expanded the list to include real estate, partnership interests, and other investment properties. The trend has been toward a broader definition of eligible investments for custodial accounts.

The custodian of the custodial account has general investment powers over the account and has discretion to apply the principal and income in the account for the benefit of the minor. The property placed in a custodial account vests immediately and irrevocably in the minor at the time of transfer. Also, the entire principal and income of the custodial account must be delivered to the minor when the custodianship ends (typically at age 18 or 21). If the minor dies during the custodianship, the balance in the account must be delivered to the minor’s estate.

The income from a custodial account is taxed to the minor unless, and to the extent that, the income is used to discharge a legal obligation of another person, in which case the income is taxed to that other person. If, for example, the funds are used to meet the parent’s legal obligation to support the minor, the income will be taxed to the parent.

The major advantages of the custodial account are its:

1. simplicity;

2. low cost; and

3. ease of administration.

The possible disadvantages include

1. loss of parental control over assets;

2. inflexible distribution requirements at termination of custodianship;

3. questions about education as a support item;

4. the prospect of the child receiving more money than he is capable of managing, or willing to apply toward the intended purposes; and

5. the revised kiddie tax rules, which reduce or eliminate tax savings.

In light of the kiddie tax rules being expanded to include full-time students under age 24, the benefits of this asset and income-shifting technique for education funding purposes are now significantly reduced. The parents can shelter from their higher tax rates only the first $2,000 (in 2015) of unearned income per year transferred to each child through the gifting of income-producing assets. Assuming the assets can earn 5% interest, this means that parents could transfer up to about $40,000 worth of assets to each child before the earnings would become subject to tax at the parents’ rather than the child’s rates.

However, for the families that might consider shifting assets to children for education funding—that is, those who are well-enough off that they would not expect to qualify for financial aid—the effort hardly seems worth the trouble. The maximum tax savings the family would enjoy by shifting the assets to a child is only $792 per year if the parents are in the 39.6% bracket and the child is effectively in the 0% percent bracket. Furthermore, once money is given to an UGMA or UTMA account, the money technically belongs to the child and so parents have no assurance that these monies will, in fact, be used for education funding.

However, if parents decide it is still advisable to use a custodial account, the types of assets that are placed in a custodial account can have a significant effect on the tax benefits. If a child is a full-time student under age 24 and, therefore, subject to the kiddie-tax rules, the parents could at least partially fund the custodial account with tax-free, tax-deferred, or low-income/high-appreciation investments in order to postpone realization of excess taxable income until the child attains age 24. Such investments include;

* Series EE savings bonds;
* zero-coupon municipal bonds;
* tax-deferred annuities;
* single-premium life insurance;
* growth stocks;
* stocks in a closely held business;
* land; and
* other growth-oriented assets that do not produce significant current income.

Gifts of Appreciated Assets to Minors

Gifts of appreciated assets to minor children have limited use for tax-favored college education funding because of the expanded kiddie tax rules.

However, in some circumstances such gifts might be a means to provide tax savings on the recognition of gains, but only if the (dependent) children recognize the gains after they become age 19, or, if students, the earlier of when they are no longer students or they become age 24. The one planning opportunity still available for such gifts in the college funding context is as a means to pay off debt incurred to pay college expenses. For example, assume that the parents, instead of liquidating appreciated assets to pay a child’s college expenses, transfer appreciated assets to the child which the child then uses, in part, as collateral for loans to pay the college expenses. Assume the student incurs secured and unsecured debt of $20,000 for college expenses by the time the child graduates from college. Assume, for illustration, that the value of the gifted assets is $20,745 after the child finishes school and that the transferred assets had a basis of $5,000 when transferred. Under current (2015) tax rules, the gain would be taxed at a 23.8% rate (maximum capital gain rate of 20% plus net investment income tax of 3.8%) if owned by the parents but, potentially, at a 0% rate if owned by the child (assuming the child is in the 10% or 15% federal income tax bracket). The tax savings is computed as shown in Figure 10.11.

**Figure 10.11**

|  |
| --- |
| **Taxable Gain Transferred from Parent to Child** |
| Market Value | $ 20,745 |
| Less Cost | ( 5,000) |
| Gain | $ 15,745 |
| Parents’ capital gain tax rate | x 0.238 |
| Parents tax | $ 3,747 |
| **Child’s tax cost** |
| Taxable gain | $ 15,745 |
| Less dependent’s deduction | ( 1,000) |
| Taxable income | $ 14,745 |
| Child’s tax rate | x 0.00 |
| Child’s tax | $ 0 |
| Family Tax Savings | $ 3,747 |

So the tax savings in this case is $3,747 and the actual economic savings are these tax savings less whatever interest was paid to carry the loans until the assets were liquidated to pay off the debt. The gift of appreciated property qualifies for the $14,000 (in 2015, $28,000 for split-gifts) gift tax annual exclusion and the parent’s holding period and basis carries over to the child.

Interest-Free Loans
and Below-Market Interest Loans

Below-market loans, interest-free or low-interest demand loans (i.e., loans that may be called at any time by the lender) are treated as follows: the lender (parent) is deemed to have made a loan to the borrower (child) at the applicable federal rate; a rate that is established and published monthly by the IRS. At the end of the calendar year, the child is deemed to have paid the parent interest at a rate equal to the applicable federal rate; therefore, the parent has interest income as if the imputed interest had been paid. The parent is then deemed to have made a gift to the child in the amount of that interest. The interest deemed to have been paid by the child will be subject to the general limitations on deductions of interest.

The imputed interest rules were devised to prevent income-splitting, but there are certain limited exceptions. The first exception to the general rule applies if the total amount of outstanding loans to a child does not exceed $10,000. However, if the loan is directly attributable to the purchase or carrying of income-producing assets, the rules do apply. What this means is that if the loan proceeds are invested in income-producing assets or placed in a savings account, the $10,000 exception will not apply.

The second exception allows a loan of up to $100,000 to escape the rules as long as the child’s net investment income (from all sources) for the year does not exceed $1,000. If the child’s net investment income does exceed $1,000, the amount of interest treated as being transferred is limited to the amount of the child’s net investment income.

The application of the $10,000 exception depends on how the specific funds are spent; in contrast, the application of the $100,000 exception depends on how much investment income the child has. The following examples illustrate these rules:

*Example 1*: Assume that a father makes a loan of $10,000 to his son who has net investment income of $2,000. The son uses the loan to pay tuition. Assuming the principal purpose of the loan is not tax avoidance, the imputed interest rules do not apply because the loan qualifies under the $10,000 de minimis exception. However, if the son had placed the $10,000 in a savings account, the interest would have to be imputed.

*Example 2*: Assume that a mother makes a $100,000 loan to her son who has no investment income. The son uses the money to buy a house. The imputed interest rules do not apply and the loan qualifies under the $100,000 exception. But, if the son had $5,000 of investment income that year, the imputed interest rules would apply. However, the imputed interest would be limited to the amount of net investment income, $5,000.

The Family Partnership

A gift to children of an interest in a family partnership can also be an income-splitting device. The tax savings are limited, however, by the kiddie tax rules for children under age 19, or age 24, if they are students. If the child is age 19 or older and not a student, or age 24 or older, the income will be taxed at the child’s tax rate.

In addition to the limitations imposed by the kiddie tax rules, several other potential pitfalls may arise when using family partnerships for family income shifting:

1. In most cases, children will not be recognized as partners unless it can be shown that the children are competent to manage their own affairs. Consequently, partnership interests owned by minors should generally be held in trust or in an UGMA account with an independent custodian.

2. Many states recognize a trust as a legal partner, but there are some that do not.

3. If the partnership interest is given to the trust by the parent, an independent trustee relationship should be established.

4. Control by the parent in any form can jeopardize recognition of the partnership interest.

5. If the trust for the children receives its partnership interest by gift and does not contribute any services, capital must be a significant factor in producing the income of the partnership in order for the Internal Revenue Service to recognize the children’s partnership interest.

6. A child’s interest in a personal service partnership (i.e., one in which most of the income is generated by commissions and fees) is generally not recognized by the Internal Revenue Service. This is because the partnership would be unable to satisfy the IRS requirement that capital be a significant income-producing factor.

S Corporations

A family-owned S corporation can be used to shift income to children in much the same way that a family partnership can. In contrast with the family partnership, S corporation stock can be owned even if capital is not a significant income-producing factor. However, this is not true in the case of a professional corporation electing S corporation treatment; shares cannot be transferred to a family member who is not licensed if the shareholders must be professionally licensed under state law to hold shares. For example, a doctor’s stock in her medical S corporation cannot be transferred to her minor daughter or to a trust for her benefit, even if it were a trust that could otherwise hold S corporation stock.

Income-shifting and income-splitting may be accomplished by transferring S corporation shares to children because the tax treatment of S corporations resembles that of a partnership. Income, losses, deductions, and credits are passed through to the shareholders and are reported on the shareholder’s individual returns. However, note that the kiddie tax rules apply to S corporation income. Therefore, the benefits of income-splitting will be limited unless the child has attained age 19 (24 if a student). Planners should keep in mind estate tax and other advantages.

In most cases, children will not be providing significant services to the corporation. However, children may be employed by the corporation to perform services commensurate with their age and abilities. Consequently, an S corporation can be used to shift income in two ways: (1) through payment for services performed for the corporation; and (2) through distributions of profits to children who are shareholders. Given the limitations imposed by the kiddie tax on unearned income, payments for services provide the best income shifting opportunity by far.

In some cases it may be wise to use a custodial account or trust to hold the minor’s stock. The use of a custodial account may be less complicated and less expensive, but does not provide for as much flexibility as a trust. In most states, the custodial arrangement ends at age 18 or age 21, at which time the children take possession of the stock. At that point, the children may use the proceeds for any purpose they desire, which may or may not include paying for their college education.

If a trust is used to hold minor children’s stock, the trust must be a Qualified Subchapter S Trust (QSST) or an Electing Small Business Trust (ESBT). What constitutes a QSST or ESBT is beyond this discussion. Generally, however, there are complex restrictions (e.g., how the trust can be structured, who can be a beneficiary, and how income can be distributed).

A QSST or ESBT is indicated when:

1. a parent does not want to give stock to a child outright;

2. a parent does not want the child to have ownership of the stock until he or she reaches a certain age;

3. parents wish to distribute income on the stock to one beneficiary and later distribute the income and stock outright to another beneficiary when the trust terminates. For example, the trust instrument could state that the income from the trust would go to the parent’s child throughout his or her lifetime, and the remainder of the trust would go to a grandchild upon the child’s death.

Using the S corporation form for a family business, and transferring shares to children is especially suitable when the family may desire to transfer ownership of the business outright to the children at some later date, as well as providing income for a college education.

Employing Children

One of the best methods for shifting income to children is to employ them in a family-owned business. Employing children has a double tax benefit. First, income is shifted to the lower tax-bracket children and, second, the parent-employer receives a deduction for the amount paid in wages. The salary paid must be reasonable in relation to the services rendered, but the work performed need not be either significant or regular. For example, a child may be employed to clean the office, cut the grass, clear sidewalks of snow, perform maintenance or janitorial services, open the mail, make deliveries, or other similar tasks.

If the business is not incorporated, the services performed by a child under the age of 18 are excluded from Social Security coverage. The business may deduct the salary or wage payment, but avoid the added expense of Social Security taxes that would be required if the compensation were paid to unrelated employees.

A parent/business owner employing a child in the business may generally claim a dependency exemption for the child if: (1) the parent/business owner furnishes more than one-half the child’s support; and (2) the child is under 19 years of age, or is a full-time student under age 24. If the child is 24 years of age or older and a full-time student, the parent is not entitled to the dependency exemption unless the child earns less than the exemption amount ($4,000 in 2015).

A child who is a dependent may not claim any personal exemption, but is allowed to claim a standard deduction equal to the greater of: (1) $1,000 (in 2015, as indexed) or (2) the sum of $350 and the dependent’s earned income, up to the appropriate standard deduction limit, e.g., $6,300 for single taxpayers for 2015; thereafter, indexed for inflation. In other words, in 2015, a child with earned income pays no income tax on the first $6,300 of earned income. Therefore, by employing a child, the business owner in the 25% bracket (in 2015) will save $1,575 in taxes for the first $6,300 in wages paid to each child. On any compensation in excess of $6,300 paid, the business owner will save the difference in taxes between the child’s low bracket amount and the parent’s 25% bracket amount.

Children over 17 years of age can work any job, whether hazardous or not, for an unlimited number of hours. Under the Federal Fair Labor Standards Act, children aged 16 and 17 are restricted to nonhazardous jobs. They may work any type of nonhazardous job for an unlimited number of hours. If children are age 14 or 15, they may work no more than 3 hours on a school day and 18 hours in a school week, and are restricted to nonhazardous jobs. Fourteen is the minimum age for most non-farm work unless the child works for the parent in a nonhazardous job in a non-manufacturing business owned by the parent. In that situation there is no minimum age. Planners must also check state and city laws regarding employment of minors.

The Gift-Leaseback Technique

The Tax Court has approved the gift-leaseback technique as a legitimate means of reducing tax liability and shifting income. In the typical situation, the taxpayer, such as a professional or perhaps a shareholder in a closely held corporation, establishes a trust for the children. Business property, such as office buildings, furniture, equipment, autos, trucks, or machinery, is transferred to the trust, which agrees to lease it back to the taxpayer. The lease payments are then deductible by the high-bracket taxpayer and reported as income to the low-bracket trust beneficiaries; or to the trust if the income is accumulated.

If the children, or the trust beneficiaries, have no other income, the first $1,000 (in 2015, as indexed) of the shifted income to each child is exempt from tax, because of the dependent’s exemption. The next $1,000, regardless of age, is taxed at the child’s tax rates. If the child is under age 19, or age 24 if the child is a full-time student, distributed income in excess of $2,000 is taxed at the parent’s rates. This can be avoided by having the trust retain the income, but trust income tax brackets are very compressed. If the child is 19 or over and not a student, the distributed income is taxed at the child’s rate. When the property is ultimately transferred to the income beneficiary, or the residual beneficiary, if different, gains on sales of assets are taxable to the beneficiary, not the grantor. The parent taxpayer will also continue to be entitled to a personal exemption for each dependent child who is at least 50% supported, so long as the dependency tests are met.

Investment Vehicles

The selection of an appropriate investment vehicle for college education funds depends on many factors, including the time until the funds are needed, whether the parent or child will be the owner of the asset, the client’s attitudes towards risk and return, tax rates, and the like. Many clients are especially interested in investments that are particularly suitable for their children who are under age 19, or under age 24 and full-time students, and thus subject to the kiddie tax rules, and that provide tax advantages or certainty of value when college costs must be paid. The following sections briefly describe some of the investments that can meet these objectives.

Investments for Children Subject to the Kiddie Tax Rules;
Investments for Tax Deferral

If funds are being transferred to a child subject to the kiddie tax rules, investments that minimize taxable income while providing relatively certain growth potential would be most suitable, since they will minimize the effect of the kiddie tax. Among those that the financial planner should consider are:

1. *Variable and universal life insurance*. The inside buildup is tax-deferred or tax-free and a child may borrow cash value without paying tax on gains in order to pay college costs.

2. *Zero coupon bonds*. Prior to JGTRRA 2003, some financial advisors favored zero coupon bonds, or deep discount bonds, as a college savings vehicle because of their low cost, simplicity, and relative safety, despite the fact that taxes on the phantom income thrown off by these bonds is due and payable annually as the deemed interest accrues. Before JGTRRA was enacted, the rates on long-term capital gains (28%) were generally higher than the generally applicable ordinary income tax rate for children (15%) so bonds were viewed as being preferable to stocks.

Under JGTRRA, qualified dividends and most long-term capital gains are generally taxed at 0% for children. On the other hand, ordinary interest income, including the phantom income thrown off by zero coupon bonds, is taxable at higher rates (i.e., 10% or 15% for most children). Because the tax rates flip-flopped when JGTRRA 2003 was enacted, zero coupon bonds are now generally less attractive as a college savings vehicle than they were prior to JGTRRA.

In another JGTRRA-related development, some advisors now recommend shifting appreciated assets to children to take advantage of the existing capital gain rate differential between children (0%) and their parents (15%, 20% or, perhaps, 23.8% depending on income levels).

3. *Municipal bonds*. Interest is free of federal income tax and, in many cases, state income tax.

4. *High-growth, low-dividend stocks*. Tax on gain is deferred until recognized upon disposition. If leveraged, interest expense offsets dividend income and increases growth potential. Note that dividend income may be subject to lower income tax rates. In this way, leveraged growth stocks are similar to deep-discount bonds, except that there is much less certainty of value when the funds are needed for college. However, if there is at least 10 years until college begins, the risk/return potential is favorable as compared with bonds.

5. *High-growth, low-dividend stock mutual funds*. These funds are similar to high-growth, low-dividend stocks except that the leveraging possibilities are more limited and some capital gains must be recognized. The gains are subject to tax when the fund declares capital gains dividends each year.

6. *Series EE savings bonds*. Tax on accruing interest is deferred on savings bonds; high certainty of value. Some taxpayers may be able to exclude income used for college expenses, as described below.

Special Income Exclusion for
Series EE and Series I Bonds

For Series EE bonds purchased after 1989 (and Series I bonds purchased after 1998), a parent who redeems these bonds—and pays certain education expenses of his child in the same year—may be entitled to exclude the accrued interest on the bonds. This exclusion is subject to the following limitations:

1. *Bond ownership requirement*. In order to qualify for the exclusion, the owner must have purchased the bonds after having attained the age of 24, and must be the sole owner of the bonds or own the bonds jointly with a spouse. The exclusion is not available to an individual who is the owner of a Series EE bond that was purchased by another individual, other than a spouse. For example, the exclusion is not available if a parent purchases a Series EE bond and puts the bond in the name of a child or another dependent. Also, the exclusion is not available for married taxpayers who do not file jointly. Furthermore, the exclusion is not available for any bonds that might be obtained as part of a tax-free rollover of matured Series E savings bonds into Series EE savings bonds.

2. *Qualified educational expenses*. Qualifying educational expenses include tuition and required fees for a taxpayer, or the taxpayer’s spouse or dependents, net of scholarships, fellowships, employer provided educational assistance, and other tuition reduction amounts at an eligible educational institution. Such expenses do not include expenses with respect to any course or other education involving sports, games, hobbies, other than as part of a degree or certificate granting program.

3. *Limitation where redemption amount exceeds qualified expenses*. If the aggregate redemption amount (i.e., principal plus interest) of all Series EE and Series I bonds redeemed by the taxpayer during the taxable year does not exceed the amount of the student’s qualified educational expenses, all interest for the year on the bonds is potentially excludable. For example, if the redemption amount is $10,000 ($5,000 each of principal and interest), and qualified educational expenses are $12,000, the entire $5,000 of interest may be excluded from income; subject to the phaseout described below. However, where the redemption amount exceeds the qualified educational expenses, the amount of excludable interest is reduced on a pro rata basis. For example, if the redemption amount is $10,000 ($5,000 each of principal and interest), and qualified educational expenses are $8,000, then the ratio of expenses to redemption amount is 80% ($8,000/$10,000) and $4,000 (5,000 x 0.80) of the interest may thus be excluded from income.

4. *Phaseout of exclusion where income exceeds certain amounts*. The exclusion is phased out for taxpayers with modified adjusted gross income (MAGI) of $77,200 (in 2015; $115,750 for joint filers) or more for the taxable year. No amount is excludable for taxpayers whose MAGI exceeds $92,200 (in 2015; $145,7650 for joint filers).[[16]](#endnote-16)

Modified Adjusted Gross Income (MAGI) is defined as the taxpayer’s adjusted gross income for the taxable year including what would otherwise be excluded foreign earned income, or certain income of residents of Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands, the partial inclusion of Social Security and Tier 1 Railroad Retirement benefits, the adjustments for contributions of retirement savings, and the adjustments with respect to limitations of passive activity losses and credits.

The amount that may be excluded when a taxpayer’s MAGI falls within the phaseout range may be determined using the following formulas.

For singles and heads of households whose MAGI exceeds $77,200:

Adjusted Exclusion = Unadjusted Exclusion x [1 – (MAGI – $77,200) / $15,000]

For married taxpayers whose MAGI exceeds $115,750:

Adjusted Exclusion = Unadjusted Exclusion x [1 – (MAGI – $115,750) / $30,000]

*Example 1*: Assume a married taxpayer filing jointly who has a MAGI of $123,950 redeems bonds worth $12,000 ($6,000 principal and $6,000 interest) and pays qualified educational expenses of $13,000. The unadjusted exclusion is $6,000 because the qualified expenses exceed the redemption amount. Therefore, the adjusted exclusion computed using the formula shown above for married taxpayers is $4,000 [$6,000 x (1 - ($123,950 - $115,700) / $30,000)].

*Example 2*: Assume a single taxpayer who has a MAGI of $86,000 redeems bonds worth $12,000 ($6,000 each of principal and interest) and pays qualified educational expenses of $9,000. The unadjusted exclusion is 75% ($9,000 / $12,000) of $6,000, or $4,500. (Remember, if the redemption amount exceeds the qualified expenses, the amount of interest that is excludable is determined by multiplying the interest by the ratio of the total expenses to the total redemption amount.) Therefore, the adjusted exclusion using the formula shown above for single taxpayers is $1,500 [$4,500 x (1 - ($86,000 - $77,200) / $15,000)].

The phaseout levels are indexed annually for inflation; consequently, the phaseout will begin at higher nominal, but essentially the same real, level of income in future years.

Investments with Certainty in
Reinvestment Rate or Return

One problem facing any accumulation program is the uncertainty regarding the rate that can be earned on reinvested income and, consequently, the uncertainty regarding the amount that will ultimately be accumulated by the target date. If your client wants certainty of value when the funds are needed to pay college expenses, the following investments should be considered:

1. *Zero-coupon bonds*. Zeros sell at a discount from face value and pay no cash interest. At maturity zeros pay their face value. Consequently, investors who hold the bonds to maturity are guaranteed that they will receive a rate of return equal to the original yield to maturity regardless of what happens to reinvestment rates over the term until the bond matures. However, most zero-coupon bonds are callable. Therefore, investors bear some risk. If the bonds are called before maturity, investors will not be able to reinvest the proceeds at a rate comparable to their original yield on the bonds.

2. *Stripped bonds*. Stripped bonds are artificially created zero-coupon bonds. These bonds are created by investment bankers who strip the coupons from the bond and sell the principal portion at a discount from face value. Strips are sometimes issued with call protection, a guarantee against early redemption of the bonds that would force investors to reinvest the proceeds at potentially lower yields. The call protection feature is especially attractive on municipal bond strips since municipal bonds are generally much more likely to be called than taxable bonds.

3. *Bunny bonds*. These are bonds issued with rights to purchase additional bonds with the same coupon and terms as the original bond. Bunny bondholders may direct their coupon payments on the bonds to be used to purchase additional bonds, thus guaranteeing their reinvestment rate of return.

WHERE CAN I FIND OUT MORE?

1. Leider and Leider, *Don’t Miss Out: the Ambitious Student’s Guide to Financial Aid* (Alexandria, VA: Octameron Associates, updated annually).

2. Leider, *A’s and B’s of Academic Scholarships: 100,000 Scholarships for Top Students* (Alexandria, VA: Octameron Associates, 2007).

3. Leider, *Loans and Grants from Uncle Sam: Am I Eligible and for How Much?* (Alexandria, VA: Octameron Associates, updated annually).

4. *Funding Education Beyond High School: The Guide to Federal Student Aid*. The guide is published by the United States Department of Education and provides definitive information about federal aid programs, including Pell Grants, Federal Direct Loans, Federal Family Education Loans (FFEL), Federal Supplemental Educational Opportunity Grants (FSEOG), Federal Work-Study (FWS), and Federal Perkins Loans. This publication can be viewed online at: www.studentaid.ed.gov.

5. *Cash for College* and *Financial Aid: You Can Afford It*. The public page of the National Association of Student Financial Aid Administrators (NASFAA) includes the complete text of two publications for students and their families at www.nasfaa.org. The *Cash for College* (2008) pamphlet summarizes basic information about getting financial aid for college. *Financial Aid: You Can Afford It* (2004) provides an overview of student financial aid.

6. *Preparing Your Child for College: A Resource Book for Parents*: This is an online version of the publication by the United States Department of Education (www.ed.gov/pubs/Prepare). The publication talks about the benefits of a college education and how to prepare children for college educationally and financially. The topics include choosing a college, how much college will cost, how the parent will be able to afford it, the most common sources of financial aid, some ways to keep college costs down, setting up a long-range plan, and sources of further information. In addition, this booklet is available as a ZIP file for anonymous FTP, and also from the Consumer Information Center on their gopher. A paper copy may be ordered by calling 1-800-USA-LEARN.

7. *Websites*. A helpful list of websites that can assist in college planning can be found on The Vanguard Group website at: www.vanguard.com. An excellent website devoted to Section 529 plans may be found at www.savingforcollege.com.

CHAPTER ENDNOTES

1. . U.S. Department of Labor, “College Enrollment and Work Activity of 2013 High School Graduates,” April 22, 2014, http://www.bls.gov/news.release/hsgec.nr0.htm [↑](#endnote-ref-1)
2. National Center for Education Statistics, Table 330.10, “Average Undergraduate Tueition and Fees and Room and Board Rates Charged for Full-Time Students in Degree-Granting Postsecondary Institutions, by Level and Control of Institution: 1963-64 through 2012-2013,” http://nces.ed.gov/programs/digest /d13/tables/dt13\_330.10.asp [↑](#endnote-ref-2)
3. . Notice 97-60, 1997-2 CB 310, Sec. 3 Q&A-1. [↑](#endnote-ref-3)
4. . [↑](#endnote-ref-4)
5. . [↑](#endnote-ref-5)
6. . Notice 97-60, 1997-2 CB 310, Sec. 6. [↑](#endnote-ref-6)
7. . IRC Sec. 529. [↑](#endnote-ref-7)
8. . As extended by the Tax Increase Prevention Act of 2014. Student loan interest deduction is scheduled to expire at the end of 2014. [↑](#endnote-ref-8)
9. . As extended by the Tax Increase Prevention Act of 2014. Tuition and fees deduction is scheduled to expire at the end of 2014. [↑](#endnote-ref-9)
10. . IRC Sec. 1(g). [↑](#endnote-ref-10)
11. . IRC Sec. 1(g)(7). [↑](#endnote-ref-11)
12. . IRC Sec. 1(g)(2)(A). [↑](#endnote-ref-12)
13. . As described in IRC Sec. 170(b)(1)(A)(ii). [↑](#endnote-ref-13)
14. . IRC Sec. 1(g)(2)(A)(ii)(II). [↑](#endnote-ref-14)
15. . IRC Sec. 1(i); Rev. Proc. 2008-66, 2008-45 IRB 1107. [↑](#endnote-ref-15)
16. . Rev. Proc. 2008-66, 2008-45 IRB 1107. [↑](#endnote-ref-16)