

Personal Financial Planning



Author:
Randi K. Grant, CPA,
PFS, CFP
*Director of Taxation and
Personal Financial Planning*
Berkowitz Dick Pollack & Brant,
Certified Public Accountants and
Consultants, LLP
Ft. Lauderdale, FL

PLANNING FOR EDUCATION COSTS

Education funding is often a client's primary concern. Clients see it as a certainty, more likely to happen before disability, retirement or death. In addition, the media bombards the public with very frightening statistics on higher education costs, showing them growing at rates significantly above the consumer price index.

Some clients may seek advice solely on covering the costs of education; they may approach a financial planner at any time from before their first child's birth to until he or she is in graduate school. A financial adviser, however, cannot plan for education costs in a vacuum. He or she must understand the client's income, discretionary cashflow, financial position, asset allocation and risk tolerance, as well as whether any disability and life insurance coverage is in effect.

Once an adviser gathers appropriate information, he or she can effectively design a plan for handling education costs. The most efficient approach is a "building block" design that starts with the foundation.

Insurance

A solid foundation ensures that clients will meet their broad education goals for their children. This includes ample life insurance to pro-

vide for education, in addition to other survivorship needs. A stand-alone term policy, with the term coinciding with the estimated completion dates of the children's educations, can be a simple and low-cost solution.

State Prepaid Tuition Programs

Depending on the state of residence, a prepaid tuition program may be available. Although many clients envision their child attending an Ivy League school and dismiss the notion of an in-state campus, state-sponsored prepaid tuition programs are another way to ensure that a college education will be available; see Sec. 529(b)(1)(A)(i).

Coverdell ESAs

Under Sec. 530, clients can contribute up to \$2,000 per year per beneficiary; all aggregate contributions to Coverdell education savings accounts (ESAs) cannot exceed \$2,000 per beneficiary per year. Contributions are not deductible, but the accounts are tax exempt; distributions made for qualifying education purposes are tax free. The contributor is subject to a modified adjusted gross income limit, with a phaseout between \$95,000 and \$110,000 for individual filers, and between \$190,000 and \$220,000 for joint filers.

Editor's note: Randi Grant is a member of the AICPA's Personal Financial Planning Credential Committee.

For more information about this column, contact Ms. Grant at rgrant@bdpb.com.

The Code provisions allowing Coverdell ESAs and Sec. 529 plans will sunset in 2010.

Qualified education expenses under Coverdell ESAs include elementary and secondary school (i.e., grades K-12) expenses, as well as higher education costs. This unique element gives parents flexibility as to when they can use an account's funds. Contributions must be made before a beneficiary turns 18 and distributed within 30 days of the beneficiary's 18th birthday.

Sec. 529 Plans

The next building block is the Sec. 529 qualified savings plan. Clients are limited in how much they can contribute to such a plan by the \$11,000 annual gift tax exclusion (\$22,000 for couples), before using their unified credit. However, under Sec. 529(c)(2)(B), clients can elect to accelerate five years of annual gifts into one year. Thus, a husband and wife can put \$110,000 into a plan at one time and not affect their unified credit. Although this would be deemed a completed gift, if the donor dies within a five-year period, a pro-rata portion would be includible in his or her estate. Also, a donor is required to file a gift tax return when making the five-year election. Sec. 529 plans are only for the costs of higher education.

Deducting contributions: While contributions to a Sec. 529 plan are not deductible for Federal income tax purposes, a deduction may be allowed on a state return to residents for contributions to that state's sponsored plan. Despite that, there are many other factors to consider, including (1) investment options, (2) fees and expenses, (3) minimum initial and subsequent contributions and (4) maximum contributions. All 50 states offer a least one Sec. 529 plan.

How to invest: Plans may either be adviser-sold or directly invested with the state or a plan custodian. Investment options may be changed only once a year. Adviser-sold plans, while typically more expensive, should be evaluated with consideration given to the value of the advice provided.

Contributor power: The person establishing a Sec. 529 account is deemed the owner and has considerable flexibility; at any time, he or she may withdraw part or all of the plan's funds. While the principal is tax free, the accumulated earnings are taxed to the owner and subject to a 10% penalty; see Secs. 529(c)(6) and 530(d)(4). The owner also has the option of naming a different beneficiary, subject to certain relationship requirements.

Another alternative: In addition to state-sponsored Sec. 529 plans, The Tuition Plan Consortium, LLC, introduced the Independent Sec. 529 plan in September 2003; see www.independent529plan.org. This plan allows clients to purchase certificates, which effectively lock-in the cost of tuition at participating colleges. Currently, over 230 colleges are taking part; the list is growing. This plan may be an excellent choice for beneficiaries nearing college age who are interested in attending one or more participating colleges and are likely to meet the admission requirements.

Contribution limit: Sec. 529 plans have no income limit (unlike Coverdell ESAs), but each plan has a maximum contribution. Currently, Louisiana has the lowest cap (at \$205,175); New Jersey and South Dakota have the highest (at \$305,000).

Sec. 529 plans can be established by nearly anyone; many states allow trusts to establish them. Using a trust provides an excellent planning opportunity. Before Sec. 529 plans, trusts were a popular vehicle for parents and grandparents to set aside education funds. Under Sec. 1(e),

trusts are currently subject to a 35% maximum income tax rate on ordinary income in excess of \$9,550. In purchasing a plan through an already funded trust, taxable income will be converted into tax-free income. In addition, the trust may invest the maximum amount allowed by the plan at one time (e.g., \$305,000 in New Jersey).

Using trust assets is also an excellent option when the donor is using his or her annual exclusion for other purposes (e.g., gifting family limited partnership interests or paying life insurance premiums).

UTMA Accounts

Many financial advisers are no longer using Uniform Transfers to Minors Act (UTMA) accounts as a tool to save for education, because the donor loses control; when the donee reaches the age of majority, he or she owns the assets. Two options are available for a donor who would prefer to have the assets in a Sec. 529 plan. He or she can use an existing UTMA account's assets to pay for expenses such as summer camp, private school or vacations, and use other money to fund a Sec. 529 plan account. The other alternative is to have the UTMA account purchase the Sec. 529 plan account. While this option does offer favorable tax consequences, the donee will assume control at majority.

Conclusion

The Code provisions allowing Coverdell ESAs and Sec. 529 plans will sunset in 2010. While many financial planners do not believe this will happen, clients must be made aware of the potential. **TIA**