School funding daze

Educate yourself on combining college funding with estate planning

Would you like to combine paying for your grandchildren's or other loved ones' college educations with your estate plan? When it comes to choosing a funding plan that also will help you achieve your estate planning goals, a little knowledge can go a long way. Three tax-advantaged options include Section 529 plans, Coverdell Education Savings Accounts (ESAs) and direct payment of tuition.

529 plans

These plans, named for the Internal Revenue Code (IRC) section that governs them, come in two types: the prepaid tuition plan and the college savings plan.

A prepaid tuition plan involves making payments today to guarantee that tuition (or a specific portion of tuition) will be covered in the future. Prepaid tuition plans may be offered by states or private educational institutions. State plans are usually good for any college or university in that state's system.

Regardless of whether you choose a state or private plan, it may be possible to transfer your prepayment from one school to another. Doing so may not be without cost, however, because some plans charge a "penalty" equal to a percentage of the tuition's value. Further, even if the plan doesn't charge anything for the change, the school of choice may be more costly than the school for which you've prepaid, leaving a funding shortfall.

A 529 college savings plan often is the better option. Contributions go into a tax-deferred account that generally is invested in mutual funds (though investment choices are limited to those offered by the plan). Withdrawals used for "qualified higher education expenses" at "eligible institutions," as defined in IRC Sec. 529, are federal income tax free. Examples of qualified costs include not only tuition and fees, but also:

- Books, supplies and equipment required for attendance,
- Room and board, subject to limits, for a student enrolled on at least a half-time basis, and
- In the case of a special needs beneficiary, expenses for special needs services incurred in connection with enrollment or attendance.

The list of eligible institutions includes virtually every accredited college and university in the United States, as well as many foreign institutions.

State tax treatment varies, and some states offer income tax incentives for contributing to their plans.

529 plans offer significant estate planning opportunities. For example, gifts to 529 plans are eligible for the $12,000 per beneficiary gift tax annual exclusion. This means that you avoid gift tax liability without having to use up any of your $1 million lifetime gift tax exemption. It also means that you avoid any generation-skipping transfer (GST) tax liability that may otherwise be incurred when, for example, a grandchild is the plan beneficiary — without using up any of your $2 million GST tax exemption.

And, you can front-load five years' worth of annual exclusion gifts ($60,000) in one year. Married couples splitting gifts can double this amount to $120,000. And that is per beneficiary. However, if you die within five years of the gift, a portion of the upfront gift will come back into your estate.

For instance, let's suppose Al and Charlotte have five grandchildren and want to set up plans for each of them. They can transfer $600,000 this year and not use any of their lifetime gift tax exemptions or their GST tax exemptions.

But if either spouse dies before 2012, his or her estate will include a portion of the gift made in 2007. If Al dies later this year, his estate will include the gifts in excess of $12,000 per beneficiary. Thus, Al's estate will include an extra $48,000 per grandchild, for a total of $240,000. The $240,000 also will be considered a GST, reducing the GST tax exemption available at Al's death.

Coverdell Education Savings Accounts

Coverdell Education Savings Accounts (ESAs) are similar to 529 plans in that they allow money to be saved tax deferred for college expenses, and withdrawals used to pay qualified expenses are tax-free. But they have two additional advantages: 1) They also can be used for expenses related to primary and secondary education, and 2) you almost always have more options for how the account is invested.

However, contribution restrictions generally make ESAs less attractive as an estate planning tool. First, the maximum annual contribution is $2,000 per account beneficiary. Second, your contributions may be further limited — or prohibited altogether — if your income exceeds certain limits. Third, you can't contribute to an ESA after the beneficiary turns 18 years old.

Another consideration is that any funds in the ESA at the time the beneficiary turns 30 (except in the case of a beneficiary with special needs) must be distributed to that beneficiary — and will be included in taxable income if not used for qualified education expenses or transferred to another qualified beneficiary (who must be related in a specified way to the original beneficiary).

Direct payment of tuition

One of the best ways to combine estate planning and college funding is to pay tuition on behalf of the student. Gifts of tuition paid directly to the institution are exempt from gift tax without counting as annual exclusion gifts or using any of your lifetime gift tax exemption. They also are exempt from GST tax without using any of your GST tax exemption.

In fact, a recent IRS ruling permitted the prepayment of future tuition as being included as a gift.

Do your homework

You can use education funding tools to also achieve estate planning goals. But choosing the combination that is right for you requires careful study.

Financial aid and 529 plans

An oft-asked question is how financial aid is affected by the various college savings plans and by other gifts. There are two aspects of financial aid: 1) federal assistance, and 2) assistance generated through the institution itself. Institution-based aid calculations can vary greatly.

With federal assistance, student-owned assets generally are included at a higher percentage than assets a student's parents own. There are exceptions. For example, a recent law now exempts student-owned 529 plans from inclusion in the calculation. 529 plans in the parents' names, however, aren't excluded.

One caveat before you rush to put your 529 plan in your child's name: Some estate planning professionals believe that the exclusion was an oversight by Congress, which had intended to include 529 plans at the parent's rate regardless of the owner, and that the oversight will be corrected. Of course, if a grandparent owns the 529 plan, the plan will be excluded.

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