Price & Farrington's Estate and Tax Planning *Fast*Faxts

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Estate, Tax , Business and Wealth Planning for Advisors and Clients

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Saving For College 101:
Where Estate and Financial Planning Meet

HAPPY HALLOWEEN!

Saving for a child's college education takes you to the intersection of *estate planning* and *financial planning*. Tax-favored college savings accounts are being marketed aggressively by financial institutions. But those who sell these accounts rarely warn that they may cause you to lose financial aid.

The Aid Formulas. If there's any chance your child will qualify for aid, here are the basics:

The federal formula is used for federally-financed aid and by public colleges and universities:

☑ 35% of a *student's own assets* are deemed available to pay his/her college costs. This 35% is applied during each year of college, so after four years 82% of the original amount of assets is depleted.

☑ Up to 5.6% of *parental assets* are deemed available for college costs. After four years, 21% is depleted.

The institutional formula is used by some private schools to award aid with their own resources. Here, 25% of a child's assets and 5% of parental assets are deemed available to pay annual college costs.

Under both formulas, outside scholarships and third-party payments (e.g., from grandparents) reduce eligibility for aid dollar for dollar. *Example:* The "U" costs $30,000 and Bobby qualifies for $14,000 of aid, leaving $16,000 to be paid. If Bobby wins a $10,000 skeet-shooting scholarship, other aid is reduced to only $4,000, so $16,000 must still be paid by the family. different *tax-favored saving options* are treated differently under the college aid formulas:

Section 529 plans allow large tax-deferred savings that remain tax-free if used for college costs. (1) ***Prepaid plans*** allow you to purchase tomorrow's academic credits at today's prices, but the dollar value of any credits redeemed generally reduces aid dollar for dollar. This is currently the worst 529 option for families who are likely to qualify for aid. (2) 529 ***Savings plans*** allow contributions to be invested, usually without any guarantee on the rate of return. These plans are treated as an asset of the owner. If a parent owns it, it's deemed a parental asset, with up to 5.6% counted against aid eligibility each year. If the child owns it, there is aid reduction up to 35% of the assets per year.

Under the current federal formula, a 529 savings plan owned by a grandparent or other trusted third party —a relative or friend— is deemed that person's property and is not considered in the aid formula, so it doesn't reduce tuition aid. *Caution:* some private colleges will ask about such plans and may count them when awarding aid.

Education IRAs (now known as Coverdell ESA accounts) have smaller contribution limits (currently $2,000 per year per beneficiary from all sources) than 529s but they allow tax-deferred savings to be applied to a wider range of costs, such as high school tuition or computer purchases. These plans are treated the same as 529 savings plans for aid purposes. Since these accounts can convert to being the child's property at 18, when opening the plan the parent should choose to remain the owner even after the child's majority.

Uniform Transfers to Minors Acts (UTMA) Accounts. These hold investments in a child's name, and their income is taxed at the child's rate when he/she is over age fourteen, rather than at the parent's higher rate. Since these accounts are deemed the property of the child, they are much worse for college aid purposes than 529 savings plans or Coverdell accounts that are owned by the parents.

Gifts from grandparents. Payments made by grandparents or other third parties towards a student's tuition made directly to the college are totally free of gift tax and don't count toward the annual $11,000 gift tax exclusion. But beware: such payments reduce aid dollar for dollar. The best strategy is for grandparents to make gifts to the student's parents so aid is reduced by no more than 5.6% of their value, rather than by 100%. Gifts to the parents are gift tax free up to $11,000 per person per year. Gifts exceeding that amount will erode the $1.5 million estate tax exemption in place in 2004 and 2005.

Trusts. Placing assets in trust for a child with the provision that the child cannot touch trust principal until a post-college age, say 25, could be a big mistake. The intent is to keep Bobby from squandering the money beginning at age 18, the age of majority. The trap is that the assets reduce Bobby's aid eligibility even though he can't use them. *Example:* A trust holds $20,000 in principal for Percival, who can't tap it until he's 25. The 35% of assets assessment reduces Per-

"What's it going to be—ice cream or a university education?

☺ ***Smart** is when you believe only half of what you hear. **Brilliant** is when you know which half to believe.*

☺ *The graduate with a science degree asks, "Why does it work?"*
The graduate with an engineering degree asks, "How does it work?"
The graduate with an accounting degree asks, "How much will it cost?"
The graduate with a liberal arts degree asks, "Would you like fries with that?"

☺ *Everybody is ignorant, only on different subjects. — Will Rogers*

☺ *I never let my schooling interfere with my education. — Mark Twain*

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cival's eligibility for aid by $7,000 every year — $28,000 total. That's $8,000 more than is in the trust! A better idea would be to set up the trust to benefit Percival's parents so that it's deemed a parental asset.

What to do? An added complication is that tax law and aid formulas are both likely to change in coming years, so parents planning now to pay college costs in 10 or 15 years can't know what the rules will be. Parents should consider saving in a tax-deferred *retirement* account such as an IRA, 401(k) or Keogh Plan. The advantages are:

☑ Retirement accounts aren't counted in aid formulas, so putting savings into them won't reduce eligibility for Sally's aid as saving outside one in a taxable account, 529 plan, Coverdell ESA or UTMA will.

☑ By saving for retirement you will be in a much better financial position to pay for college without worrying about what you'll live on once you retire.

Beware of a trap: While funds from some IRAs can be withdrawn penalty-free to pay for qualified higher education costs, all the funds withdrawn will be considered income in the financial aid formulas.

Topic: Can 529 Plans Hurt Financial Aid?

Predicting just how withdrawals from a tax-free 529 college-savings plan will be handled by financial aid offices ten years from now is tricky business. Yes, they'll reduce financial aid eligibility, but that doesn't mean you should jettison your plan. Right now 529s generally have little impact on aid; as parental assets, no more than 5.6% are deemed available for college costs (*see main article*). *But beware*: some private universities may assess 529 plans differently.

Depending on the parents' ages, some assets are exempt from the financial aid calculations. If you're 45 years old, the first $42,100 of your assets are protected before the college will touch a dollar. Those protection levels are higher if the parents are older. *Example:* If you're 45 and had $100,000 in a 529 plan and no other investments when your child started college, your first year financial aid package would be reduced by just $3,242.40 (5.6%of $57,900). This number would be even smaller for families that have another child already in college. Note that these are the current rules, and they could change as Congress is now getting around to clarifying them. For example, Congress could decide that 529 plans should be considered assets of the *beneficiary*. If that happened, up to 35% of the balance could be considered available for tuition each year!

Be strategic. Be sure to avoid overfunding a 529. Sure, excess funds can be transferred among family members, including cousins and grandkids. They can also be used for graduate school expenses. But withdrawals used for nonqualified expenses are taxed as ordinary income and hit with a 15% penalty (the taxes and penalties are applied to the earnings, not the original contributions). Examples of "qualified expenses" are tuition, room and board, books, fees and supplies. The ideal situation is to have no money left over once the kids graduate. If you think you might have too much in your 529, consider putting some money in tax-efficient mutual funds so when the time comes to make withdrawals, the money will be taxed at the maximum 15% long-term capital gains rate when you use it for something else

Topic: Placing UTMA Assets Into a College Savings Plan.

UTMA stands for Uniform Transfers to Minors Account. Assets given to a minor can be placed in one of these accounts, which is managed on the minor's behalf by an adult custodian. The custodian can use the assets only for the minor's benefit, but there is wide latitude, including, for example, moving the money into a 529 plan. *Caution:* by federal law, contributions to a 529 must be made *in cash*. This would require selling the assets in the UTMA, triggering a possible capital gains tax. The proceeds can then be invested in a 529 naming the child as beneficiary.

Moving the assets from an UTMA to a 529 will remove them from the child's control. The UTMA—which is really an irrevocable trust created on behalf of the child—will actually be the owner of the 529. The custodian retains the power to decide how the money will be invested within the 529 plan until the beneficiary of the UTMA reaches the age of majority. At that point the UTMA is essentially dissolved and the beneficiary now becomes the owner and can decide what to do with the money. Of course, if money withdrawn from a 529 is used for things other than college expenses, the owner will owe ordinary income taxes and a 10% penalty. So, unlike an UTMA, there is a disincentive for the child to withdraw the money and run off to Europe.

In addition, money invested in a 529 plan has the potential to grow tax-deferred, eliminating the tax your children have to pay on their college accounts each year. And if the assets are used for "qualified expenses" there is no capital gains tax due on any profit from a 529 when they are withdrawn.

Buying a car. You don't have to liquidate the entire UTMA in order to invest in the 529. If little Susie will need a car when she starts college, leave enough in the UTMA's existing investments to cover this expense. That way you can withdraw the money without a penalty (transportation expenses are never considered a "qualified" use of 529 funds).

Leftovers. If there's money left in the 529 after Susie graduates from college, it doesn't need to be spent before a certain age. Maybe she'll decide someday to go to graduate school. Or if she has a child of her own, she can change the beneficiary from herself to her child (note: there could be gift tax issues here). If she wanted to use the leftover money in the 529 to take a vacation or buy a house, she could. Since neither is a "qualified" expense, ordinary income tax and the 10% penalty would apply, but only to the gain.

A word of caution: Any additional contributions made to the UTMA/529 will become the property of the child once he/she reaches majority age. So if mom or dad or the grandparents want to add to the college fund, they could open a second, non-UTMA 529 plan. Assets in the account will never become the property of the beneficiary, no matter how old she is, unless you want to transfer ownership to her.

Estate planning, financial planning, ownership issues, taxes, asset protection — all of these important topics converge into the five-way intersection represented by college planning. As always, we will work with the other members of your estate and financial planning team to help you make the smartest decisions for yourself and your family. ■

Glen D. Pric[illegible]