2 Saving for College

Tab 2 Contents

Saving for College Planning Strategies 2-1
Transfers to Children—How to Save Tax 2-2
Saving for College Using 529 Plans and ESAs 2-5
Saving for College Using IRAs 2-7
Saving for College Using a Roth IRA 2-10
Saving for College Using U.S. Government Savings Bonds 2-11
Saving for College Using Life Insurance 2-12
Education Tax Credits—High-Income Parents 2-15
Planning for Obtaining Financial Aid 2-16

Planning for Tax Law Changes

- The phase-out ranges for traditional IRAs have been changed for taxpayers filing as MFJ, single, or HOH. See *Saving for College Using IRAs,* page 2-7.
- The phase-out ranges for Roth IRAs have been changed for taxpayers filing as MFJ, single, or HOH. See *Saving for College Using a Roth IRA,* page 2-10.
- The phase-out ranges for the U.S. Savings Bonds Exemption have been changed for taxpayers filing as MFJ, single, or HOH. See *Saving for College Using U.S. Government Savings Bonds,* page 2-11.
- The interest rates for U. S. Series EE and Series I bonds have been revised. See, *Saving for College Using U.S. Government Saving Bonds,* page 2-11.
- For high income taxpayers, the personal exemption phase out ranges may reduce or eliminate the tax benefit for claiming the exemption for a student. If the parent could claim the exemption but loses the benefit due to the phase-out range, the student will not be able to claim the credit. See *Education Tax Credits—High-Income Parents,* page 2-15.

Saving for College Planning Strategies

Following is a summary of planning strategies used in this Tab.

- If a child is not subject to the Kiddie Tax (child's parents are no longer living or the child is married), transferring assets to the child taxed in a lower tax bracket can save tax. See *Transfers to Children—How to Save Tax,* page 2-2.
- If a child is subject to the Kiddie Tax, the parents should consider transferring certain assets to the child that will produce little or no taxable investment income during the year, such as tax-free municipal bonds. If a parent (or grandparent) is receiving Social Security benefits, transferring tax-free municipal bonds to the child will avoid both Kiddie Tax to the child and reduce taxable Social Security benefits to the parent (or grandparent). See *Transfers to Children—How to Save Tax,* page 2-2.
- Kiddie Tax is also avoided by investing in U.S. government savings bonds where accrued interest is not taxable until the bond is redeemed to pay for college. An alternative could be to have the parent purchase the bonds. Kiddie Tax is avoided because the bond is not in the child's name. The parent can then exclude the interest from income when the bonds are redeemed if the bond proceeds are used to pay for qualified higher education expenses of the child. See *Transfers to Children—How to Save Tax,* page 2-2.

continued in next column

Saving for College Planning Strategies continued

- Kiddie Tax is also avoided by investing in mutual funds, securities, and other capital gain-producing property that pays little or no dividends. Assets such as land can be purchased in the hopes it will appreciate in value. Capital gains are only recognized when the asset is sold, thereby producing tax-deferred savings. Unrealized gains are not subject to Kiddie Tax. If the child is not claimed as a dependent in the year the assets are sold, the child may be able to offset taxable capital gains with education credits to avoid any negative impact from the Kiddie Tax. See *Transfers to Children—How to Save Tax,* page 2-2.
- Rather than transfer money into a child's account which may be subject to Kiddie Tax, consider the benefits of using a 529 plan (Qualified Tuition Plan) or ESA (Coverdell Education Savings Account). Although contributions are not deductible, earnings grow tax free and distributions used for qualified higher education expenses are tax free. See *Saving for College Using 529 Plans and ESAs,* page 2-5.
- A 529 plan or ESA may help a child qualify for financial aid because the assets are left in the parent's name, not the child's. The child's assets are assessed by a financial aid need-based formula at 20%, while a parent's assets are assessed at a maximum of 12%. Therefore, any tax savings by transferring assets to a child may be significantly reduced when considering need-based financial aid. See *Saving for College Using 529 Plans and ESAs,* page 2-5.
- A 529 plan or ESA may also help keep gifted money earmarked for college. If the money is transferred to the child to take advantage of lower tax rates, the child will have full access to the money once he or she reaches the age of majority. The child could decide to buy a car or vacation in Mexico rather than spend the money on college. See *Saving for College Using 529 Plans and ESAs,* page 2-5.
- Rather than transfer money into a child's account, a parent can retain control over the funds used for their child's education by making contributions to an IRA. Tax on deductible contributions is deferred, and tax on earnings is deferred until the funds are withdrawn to pay for college. Distributions used for qualified higher education expenses are not subject to the 10% early withdrawal penalty. See *Saving for College Using IRAs,* page 2-7.

continued in next column

Saving for College Planning Strategies continued

- A child subject to tax on earned income can reduce or avoid tax by using gifted money from parents (or grandparents) to make deductible IRA contributions (assuming the child also has earned income that qualifies for an IRA contribution). Later, the child can take distributions from the IRA to pay qualified higher education expenses and not be subject to the 10% early withdrawal penalty. If the child is not claimed as a dependent in the year the IRA money is withdrawn, tax on the distribution can be offset by education tax credits. See *Saving for College Using IRAs,* page 2-7.
- Permanent life insurance can be used as a planning tool for college expenses. If structured properly, a permanent life insurance contract provides for tax-deferred earnings and tax-free withdrawals by taking a loan against the cash value. In addition, permanent life insurance provides a tool to assist a taxpayer in financial aid planning. See *Saving for College Using Life Insurance,* page 2-12.
- If a parent's modified AGI exceeds the limits for claiming a credit or deduction for qualified higher education costs, the parent can choose not to claim an exemption for a dependent student. By choosing not to claim the student as a dependent, the student can then claim a nonrefundable education credit. The student can also deduct any qualifying student loan interest paid. The dependent student is not entitled to claim his or her own exemption. This planning strategy works even if the parent actually pays the educational expenses. The payments are considered gifts to the student and then treated as if the student paid the expenses for purposes of claiming the tax credit. See *Education Tax Credits—High-Income Parents,* page 2-15.

Transfers to Children— How to Save Tax

Cross References

- Form 8615, *Tax for Certain Children Who Have Unearned Income*
- Form 8818, *Optional Form to Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989*
- Pub. 929, *Tax Rules for Children and Dependents*
- Pub. 970, *Tax Benefits for Education*

Tax Issue

In order to save for a child's education, some parents transfer assets into a child's name to take advantage of the child's lower tax rate. Children typically are in a lower tax bracket than their parents and shifting income to a lower tax bracket can be an effective tax planning strategy. One way to accomplish this is for parents to gift income-producing assets to custodial accounts in their child's name under the Uniform Transfers to Minors Act (UTMA). These custodial accounts control the assets until the child reaches the age set by state law (age 21 in most states). Alternatively, the parents can simply fund a savings account in the child's name. The income generated from these accounts is taxed to the minor child. However, if these accounts generate over a certain amount of interest income for the year ($2,100 for 2015), the "Kiddie Tax" rules will apply, meaning that part of the child's income will be taxed at the rate of the parents instead of the child's tax rate.

Applicable Tax Law

- Income in savings accounts and custodial accounts is taxed to the minor child. The original uniform law was the Uniform Gifts to Minors Act (UGMA), which has been replaced in almost all states by some version of the Uniform Transfers to Minors Act (UTMA), a 1986 update to UGMA.
- If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.
- Investment income is generally defined as "unearned income" and includes interest, dividends, and capital gains.
- Earned income is wages, tips, and other payments for personal services performed. Earned income also includes distributions from qualified disability trusts.
- When a child has both unearned and earned income, each item of income is addressed separately to calculate tax.
- Children do not pay taxes on the first $1,050 (for 2015) of annual income due to the standard deduction.
- The second $1,050 of interest income is taxed at 10%, and the Kiddie Tax is triggered when investment income exceeds $2,100 for the year.
- When a child is subject to Kiddie Tax, the child's unearned income over $2,100 (2015) is taxed at the parents' marginal tax rate if that rate is higher than the child's, and the child will need to file Form 8615, *Tax for Certain Children Who Have Unearned Income.*
- The Kiddie Tax rules apply when the child is:
  1) Under age 18 at the end of the year,
  2) Age 18 at the end of the year, and the child did not provide more than half of his or her support with earned income,
  3) A student, age 19–23 at the end of the year, and the child did not provide more than half of his or her support with earned income.
- The AMT exemption for children subject to Kiddie Tax is the lesser of: (1) $7,400 plus earned income, or (2) the AMT exemption available to other taxpayers.
- Age is determined on January 1, and a child born on January 1 is treated as having reached that age on the

last day of the prior year. For example, a child born on January 1, 1997 celebrates his 19th birthday on January 1, 2016. However, he is treated as having reached age 19 on December 31, 2015, and therefore is age 19 for tax year 2015.

- Scholarships received by the child from an educational institution are not included in determining the amount of total support.
- Child includes a legally adopted child and a stepchild.
- A child does not have to be claimed as a dependent in order to be subject to the Kiddie Tax.
- If the parents have more than one child required to file Form 8615, income over $2,100 for all children is included.
- If the child's interest and dividend income (including capital gain distributions) totals less than $10,500, the child's parent may be able to choose to include that income on the parents' return rather than file a separate return for the child.
- In order for a parent to elect to include a child's income on the parent's return, all of the following must be true.
  1) The child was under age 19 (or under age 24 if a full-time student) at the end of the year,
  2) The child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends),
  3) The child's gross income was less than $10,500,
  4) The child is required to file a return unless the parent makes the election,
  5) The child does not file a joint return for the year,
  6) No estimated tax payment was made for the year, and no overpayment from a previous year (or from any amended return) was applied to this year under the child's name and Social Security number, and
  7) No federal income tax was taken out of the child's income under the backup withholding rules.
  8) The parent who is qualified to make the election or files a joint return with the child's other parent.
- If the above provisions are met, the parent includes the child's income on their tax return by completing Form 8814 and attaching it to the return. The child is not required to file a return.
- The Kiddie Tax rules do not apply if:
  1) The child's unearned investment income does not exceed twice the amount of the minimum standard deduction for dependents ($1,050 multiplied by 2 equals $2,100 for 2015),
  2) The child is not required to file a tax return,
  3) Neither of the child's parents were living at the end of the tax year, or
  4) The child is married and files a joint return for the tax year.

- Interest income on bonds issued by governments (city, state, federal) is generally tax exempt.
- Interest income earned on U.S. Savings Bonds does not need to be reported until the bond is redeemed.
- The appreciated value of a capital asset is generally not taxed until the capital asset is sold.

Tax Planning Strategies

Avoiding Kiddie Tax. When planning for college, transferring ownership of assets to children can save taxes. If a child is not subject to the Kiddie Tax (*examples:* child's parents are no longer living or the child is married), the child is taxed on income from his or her assets at a lower tax rate (as low as 10%, or 0% for long-term capital gains). If a child is subject to the Kiddie Tax, parents should consider investing in certain assets that will produce little or no taxable income during the year to reduce the child's investment income subject to the Kiddie Tax.

Note: Assets that generate income must actually be transferred to the child's name, or the income will remain taxable to the parents.

Tax-exempt bonds. Interest on a bond used to finance government operations is generally not taxable if the bond is issued by a state, the District of Columbia, a U.S. possession, or any of their political subdivisions. Investments in these types of bonds can be an effective strategy to shield income from tax. If a parent (or grandparent) is receiving Social Security benefits that are taxable based on tax-exempt municipal bond interest, the parent (or grandparent) can reduce tax by transferring ownership of the municipal bonds to the child.

U.S. Savings Bonds. U.S. Series EE savings bonds issued from May 2015 through October 2015 earn a fixed rate of 0.30%. U.S. Series I savings bonds bought from May 2015 through October 2015 earn zero percent. Taxpayers postpone reporting the interest until the bond is redeemed. If the bonds are purchased in the name of the child, Kiddie Tax is avoided on the interest for each year prior to the year the bond is redeemed.

An alternative could be to have the parent purchase the bonds. Kiddie Tax is avoided because the bond is not in the child's name. The parent may then be able to exclude part or all of the interest income from the savings bonds if they are redeemed in the same year the bond proceeds are used to pay for qualified higher education expenses of the child.

Mutual funds, securities, and other capital gain-producing property. Some mutual funds and securities are focused on capital growth and do not pay dividends. Assets such as land can be purchased in the hopes it will appreciate in value. Generally, capital gains will only be recognized when the asset is sold, thereby producing tax-deferred savings. Unrealized gains from these types of assets are not subject to Kiddie Tax. If these types of assets are transferred to a child, Kiddie Tax may be avoided until the assets are sold to pay for the child's college. Then, if the child is not claimed as a dependent in the year the assets are sold, the child may be able to offset taxable capital gains with education credits and thus avoid any negative impact from the Kiddie Tax.

Examples

Example #1: For 2015, a married couple in the 35% tax bracket transfers a $25,000 taxable bond that pays 10% to their 10-year-old daughter, Kristy. Kristy receives $2,500 of investment income from the bond and has no other income for the year. If the parents had kept the bond, they would have paid $875 in tax on the interest (35% of $2,500). Instead, Kristy is taxed on $1,450 of taxable income ($2,500 gross income reduced by $1,050 standard deduction) under the Kiddie Tax rules. Although a portion of the tax is calculated at Kristy's parents' rate, total tax is still reduced. The tax is figured as follows:

First $1,050 of interest income (Kristy's standard deduction)	$ 0
Second $1,050 of interest income taxed at Kristy's rate (10% of $1,050)	105
Remaining $400 taxed at parents' rate (35% of $400)	140
Total	$245

Transferring the bond to Kristy results in an overall tax savings of $630 ($875 – $245) per year.

Example #2: Assume the same facts as Example #1, except that Kristy is not subject to the Kiddie Tax because both her parents are deceased, and the bond was gifted to her by her custodial grandparents. All her taxable income is taxed at her own 10% tax rate. Her total tax is $145 (10% of $1,450).

Example #3: Assume the same facts as Example #1, except that Kristy is age 17 and has $4,000 of W-2 income as a cashier during the summer and additional investment income of $500 from CD interest. Her total income is $7,000 for 2015 ($2,500 + $4,000 + $500). Kristy claims a standard deduction of $4,350 (earned income plus $350), leaving taxable income of $2,650. Kristy pays tax at her parents' rate on $900 ($3,000 investment income minus $2,100). She pays tax at her own rate on the remaining $1,750 of her taxable income. The calculations are broken down as follows:

Investment income	$3,000
Earned income	4,000
Total	$7,000
Minus standard deduction (earned income plus $350)	(4,350)
Taxable income	$2,650
First $1,050 of investment income	$ 0
Second $1,050 of investment income taxed at 10% rate	105
Balance of $900 investment income taxed at parents' 35% rate	315
$4,000 earned income minus remaining standard deduction of $3,300 ($4,350 – $1,050)	
$700 earned income tax at 10% rate	70
Total tax	$ 490

Example #4: Assume the same facts as Example #3, except that Kristy's parents did not transfer the bond into Kristy's name. Her tax is calculated as follows:

Investment income	$ 500
Earned income	4,000
Total	$4,500
Minus standard deduction (earned income plus $350)	(4,350)
Taxable income	$ 150
Kristy's tax (10% rate)	$ 15
Parents' tax on $2,500 (35% rate)	$ 875
Combined tax ($15 + $875)	$ 890

Total tax saved is $400 ($890 – $490) if the bond is transferred to Kristy's name. The tax savings in Example #4 is less than the tax savings in Example #1. This illustrates that as Kristy ages and starts to earn other income, the yearly tax savings from income shifting decreases. In this situation, the parents may want to consider using a combination of other tax-advantaged investment strategies to save for Kristy's college.

Possible Risks

- While the overall tax impact can be reduced by income shifting to children, the Kiddie Tax reduces the ability to fully maximize tax savings. The Kiddie Tax rules have expanded to include dependent children up to age 24 who are students, significantly reducing the benefit of shifting large assets into a child's name in order to save money for college. Thus, it is important to consider the tax impact of account ownership since the income and taxes due affect the overall return on an investment. A combination of different strategies may be a better approach in some cases, including the consideration of other tax-advantaged alternatives for saving for college.
- If a child expects to apply for financial aid, parents should not save money for college in the child's name. The child's assets are assessed by a financial aid need-based formula at 20%, while a parents' assets are assessed at a maximum of 12%. Therefore, any tax savings is significantly reduced when considering need-based financial aid.

  Note: If the family will not qualify for need-based financial aid because of very high-income, they should invest in the strategy that produces the highest tax savings.
- If money is gifted to a child to save for college, the child will have full access to the money once he or she reaches the age of majority. The child could decide to buy a car or vacation in Mexico rather than spend the money on college.
- Because of the annual purchase limit on U.S. Savings Bonds, it may take many years to accumulate enough U.S. Savings Bonds to make a meaningful difference in tax.

- There are no guarantees when investing in high-risk investments such as mutual funds, securities, and other investments that produce capital gains. A tax savings strategy designed to reduce tax can easily be cancelled if the taxpayer is forced to sell the investment at a loss.

Court Cases

Court Case: A minor child was taxed at his parents' higher marginal tax rate on unearned income from investment of a personal injury award. At the end of 1987, the child was a minor under age 14 and both his parents were alive. The child received taxable investment income of $13,439 based on funds received as a result of injuries. None of the income resulted from any assets transferred to him from his parents. The IRS determined that the child was liable for payment of federal income taxes in the amount of $4,327 under the Kiddie Tax rules. The child argued that the rule was unconstitutional in that the classification has no reasonable basis, considering a child's earned income is taxed at the lower child's tax rate, whereas his unearned income (that did not result from assets transferred from a parent) is taxed at the parents' higher rate. The court disagreed and ruled that the provision in dispute does not rise to the level of a constitutional violation. The court said the Kiddie Tax rule on a child's investment income applies, even if the income is not derived from assets transferred from a parent. *(Carlton,* U.S. District Court, Northern District of Mississippi, Western Division, October 29, 1991)

Saving for College Using 529 Plans and ESAs

Cross References

- Form 1099-Q, *Payments From Qualified Education Programs (Under Sections 529 and 530)*
- Pub. 970, *Tax Benefits for Education*
- IRC §529, *Qualified tuition programs*
- IRC §530, *Coverdell education savings account*

Tax Issue

In order to save for a child's education, many parents have transferred assets into a child's name to take advantage of the child's lower tax rate. However, if the child's education account generates over a certain amount of income for the year ($2,100 for 2015), the "Kiddie Tax" rules will apply, meaning that part of the child's income will be taxed at the parents' rate instead of the child's tax rate.

There is also a danger of transferring assets to a child because the child could decide to use money intended for college on something else once the child turns the age of majority. Parents may need to consider other tax-advantaged alternatives for saving for college than simply transferring money to a child.

Applicable Tax Law

- When a child is subject to Kiddie Tax, the child's unearned income over $2,100 (2015) is taxed at the parents' marginal tax rate if that rate is higher than the child's. The Kiddie Tax rules apply when the child is:
  1) Under age 18 at the end of the year,
  2) Age 18 at the end of the year, and the child did not provide more than half of his or her support with earned income,
  3) A student, age 19–23 at the end of the year, and the child did not provide more than half of his or her support with earned income.
- Contributions to qualified tuition plans (QTPs) but educational savings accounts (ESAs) are not deductible for federal tax purposes and earnings accumulate tax free.
- QTP contributions have no annual limitation, whereas ESA contributions are limited annually to $2,000 per beneficiary.
- Distributions from QTPs and ESAs are not taxable if less than the beneficiary's adjusted qualified education expenses in the year of distribution.
- Contributors can contribute to both a QTP and an ESA in the same year for the same designated beneficiary.
- Qualified expenses for QTP distributions are reduced by tax-free assistance (scholarships, fellowships, grants, employer-provided assistance, veterans benefits, and any other nontaxable payments except gifts or inheritances), and amounts used to figure an education credit.

Tax Planning Strategies

Rather than transfer money into a child's account (which may be subject to Kiddie Tax), parents can retain control over the funds, plus use tax-free earnings to fund the child's education by making contributions to 529 plans and ESAs.

Qualified tuition plans (QTPs) or 529 plans. A QTP (or 529 plan as they are also commonly known) can be either a state plan that allows contributions to an account to pay expenses of a beneficiary or a state or educational institution plan that allows prepayment of qualified education expenses.

There are no annual contribution limits, and many plans have contribution limits in excess of $200,000. Contributions cannot exceed the amount necessary to provide for the qualified education expenses of the beneficiary. There may be gift tax consequences if the contribution, plus any other gifts, to a particular beneficiary exceed $14,000 during the year. There are no age or income limitations, and any individual can contribute to a QTP, even the beneficiary. Contributions to a QTP are not deductible for federal income tax purposes, but many states allow a deduction for state income tax purposes. Earnings grow tax free, and distributions for qualified higher education expenses are not taxable. Qualified higher education expenses for QTP distributions include:

- Tuition, fees, books, supplies, and equipment.
- Room and board for students who are enrolled at least half-time (most universities set room and board allowances for students who live on campus, off campus, and with parents. Check the school's financial aid website for costs of attendance).
- Computer technology or equipment if the computer technology or equipment is required for enrollment or attendance.
- Expenses for special needs services needed by a special needs beneficiary if incurred in connection with enrollment or attendance.

Distributions are not taxable if they are less than the beneficiary's adjusted qualified expenses for the year. Nontaxable distributions are not reported. If distributions are more than adjusted expenses, a portion of the earnings is taxable and may be subject to a 10% additional tax.

Coverdell education savings accounts (ESAs). ESAs are accounts similar to IRAs and are used to pay qualified education expenses of a designated beneficiary. The contribution limit for 2015 is $2,000 per beneficiary, and contributions for 2015 must be made by April 15, 2016. Contributions cannot be made once the beneficiary is age 18, and the balance must be distributed by age 30. Age limits do not apply to beneficiaries with special needs. The account must be owned by the beneficiary or the parent. Earnings can grow tax free and distributions for qualified expenses are not taxable. Qualified expenses include higher education expenses, primary and secondary school (K–12) expenses, and contributions to a QTP for the designated beneficiary. Higher education expenses include:

- Tuition, fees, books, supplies, and equipment.
- Room and board for students who are enrolled at least half-time.

K–12 expenses include:

- Tuition, fees, books, supplies, and equipment.
- Room and board at school, and uniforms.
- Computer technology used by the student.

Distributions are not taxable if they are less than the beneficiary's adjusted qualified expenses for the year. Nontaxable distributions are not reported. If distributions are more than adjusted expenses, a portion of the earnings is taxable and may be subject to a 10% additional tax.

Examples

Example: Taking distributions from a QTP can affect the ability to claim an education credit. In 2015, Mary withdrew $4,500 from her QTP. Her qualified expenses are listed below. Mary's parents claimed an American Opportunity Credit using expenses of $4,000.

Tuition and fees	$6,000
Room and board	3,000
Less expenses used to claim education credit	(4,000)
Adjusted qualified expenses	$5,000

Mary's distribution was not taxable because it is less than her adjusted expenses. Although Mary received Form 1099-Q, she did not need to report the distribution on her return.

Possible Risks

- Coverdell ESA contributions are limited to $2,000 per beneficiary per year. The ESA alone may not be enough to fund the child's college education.
- Qualified education expenses are reduced by tax-free assistance and amounts used to figure an education credit. The same education benefits cannot be used for both an education credit and a nontaxable distribution from a QTP or ESA.
- Investment options may be limited when contributing to a QTP that is set up by the college or state administering the QTP.
- If the state or educational institution has a QTP that allows prepayment of qualified education expenses, there is a strong financial incentive for the student to attend college in that particular state or that particular educational institution. The student (or parents) may have reasons to change their mind about which college to attend between the time the QTP is first funded and the time the student is ready to attend college.

Court Cases

Court Case: Debtors claimed the funds in their section 529 college education account should be excluded from the bankruptcy estate. The debtors' oldest daughter was the designated beneficiary of the college account. The debtors deposited an initial $14,500 into the account. A grandmother of the beneficiary contributed an additional $40,000 to the account. Two weeks after opening the college account, the debtors filed for Chapter 7 bankruptcy. The debtors tried to claim the college education account belonged to their minor child and that they were simply in possession as custodians of the account.

In the plan description, it said: "...the account and all rights under the participation agreement belong to the account owner and not to the designated beneficiary. The account owner retains control of how and when the account assets are used...

continued on next page

The account owner owns all contributions made to an account, as well as all earnings credited to the account. Individuals other than the account owner that contribute funds to an account have no subsequent control over the contributions."

The court noted that as the account owner, the debtors could terminate the account at any time. Moreover, if the debtors terminated the college account, the account balance would be distributed to them. Thus, the bankruptcy court ruled that the section 529 college education account for their minor child was the property of the debtors, including the contributions made by the grandmother. As such, the college account was property of the bankruptcy estate and no exclusion was allowed. *(Bourguignon,* U.S. Bankruptcy Court, District of Idaho, September 23, 2009)

Saving for College Using IRAs

Cross References

- Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*
- Form 8606, *Nondeductible IRAs*
- Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)*
- Pub. 970, *Tax Benefits for Education*

Tax Issue

In order to save for a child's education, many parents have transferred assets into a child's name to take advantage of the child's lower tax rate. However, there is a danger of transferring assets to a child because the child could decide to use money intended for college on something else once the child turns the age of majority. Although transferring assets into the child's name to utilize lower tax rates may save taxes, the risk of giving the child access to the money may cause parents to consider other tax-advantaged alternatives for saving for college.

Applicable Tax Law

- Traditional IRA phaseouts for active participation in employer plan for 2015:
  - Married Filing Jointly or Qualifying Widow(er): $98,000 to $118,000.
  - Single, Head of Household, or Married Filing Separately and did not live with spouse at any time during the year: $61,000 to $71,000.
  - Married Filing Separately and lived with spouse at any time during the year: $0 to $10,000.
- Traditional IRA contribution limits for 2015:
  - Under age 50: $5,500.
  - Age 50 and older: $6,500.
- When a child is subject to Kiddie Tax, the child does not pay taxes on the first $1,050 (for 2015) of annual income due to the standard deduction.
- When a child is subject to Kiddie Tax, the second $1,050 of income is taxed at 10%. The Kiddie Tax (at the parents' marginal tax rate) is triggered when investment income exceeds $2,100 for the year.
- The 10% early distribution penalty does not apply to IRA withdrawals if used to pay qualified education expenses of the taxpayer, spouse, or any child or grandchild of the taxpayer or spouse.
- A dependent child can make a deductible IRA contribution of up to $5,500 if the child has at least $5,500 of earned income in 2015.

Tax Planning Strategies

Rather than transfer money into a child's account (which gives the child access to the money at the age of majority), parents can retain control over the funds used for their child's education by making contributions to an IRA.

In addition to contributions made to the parents' IRA, the child can also make contributions to his or her IRA, provided the child has earned income. Distributions used for higher education expenses are not subject to the 10% penalty. If the child has earned income for the tax year, the IRA contribution will lower any current tax liability of the child (and also lower any Kiddie Tax on unearned income). Later, the child can take distributions from the IRA to pay education expenses and not be subject to the 10% early distribution penalty.

Examples

Example #1: Jerry and Louise have a daughter, April, age 8. They are in the 35% tax bracket for tax year 2015 and are expected to stay in that tax bracket for years to come. They both have qualified retirement plans at work so they are not allowed to make deductible IRA contributions due to the level of their income. For the next 10 years, they plan to transfer $10,000 per year into a mutual fund in April's name which is expected to earn an average of 6% annually in fully taxable non-qualified dividends and interest income. April is not expected to earn any other money during this 10-year period. At the end of 10 years, Jerry and Louise hope April will have enough money to fund her college education when April turns age 18.

For simplicity purposes, assume inflation adjusted amounts for tax purposes are all equal to the 2015 tax year rules. Assume the taxes due on April's earnings are withdrawn from the mutual fund to pay the taxes (assume no capital gains on withdrawals). Assume the Kiddie Tax applies to April's earnings (first $1,050 tax is 0%, second $1,050 tax is 10%, above $2,100 tax is 35%). April's mutual fund balance is expected to grow as follows.

continued on next page

	Contribution		Earnings		Taxes		End Balance
Year 1	$10,000	+	$ 0	–	$ 0	=	$10,000
Year 2	$10,000	+	$600	–	$ 0	=	$20,600
Year 3	$10,000	+	$1,236	–	$19	=	$31,817
Year 4	$10,000	+	$1,909	–	$86	=	$43,641
Year 5	$10,000	+	$2,618	–	$286	=	$55,973
Year 6	$10,000	+	$3,358	–	$545	=	$68,785
Year 7	$10,000	+	$4,127	–	$814	=	$82,098
Year 8	$10,000	+	$4,926	–	$1,094	=	$95,930
Year 9	$10,000	+	$5,756	–	$1,385	=	$110,301
Year 10	$10,000	+	$6,618	–	$1,686	=	$125,233

At the end of year 10, April has $125,233 of after-tax savings to pay for her college education. However, because the money is in her name, assuming age 18 is the age of majority, she can choose to buy a new car and vacation in Mexico rather attend college.

Example #2: Assume the same facts as Example #1, except rather than transfer the money into a mutual fund in April's name, Jerry and Louise both make nondeductible contributions to their traditional IRAs each year ($5,000 into each IRA). Assume they have no other funds invested in traditional IRAs. Assume the nondeductible combined IRA contributions each year go into the same type of fund as in Example #1. Their IRA fund balance is expected to grow as follows:

	Combined Contributions		Earnings		Taxes		End Balance
Year 1	$10,000	+	$ 0	–	$0	=	$ 10,000
Year 2	$10,000	+	$ 600	–	$0	=	$ 20,600
Year 3	$10,000	+	$1,236	–	$0	=	$ 31,836
Year 4	$10,000	+	$1,910	–	$0	=	$ 43,746
Year 5	$10,000	+	$2,625	–	$0	=	$ 56,371
Year 6	$10,000	+	$3,382	–	$0	=	$ 69,753
Year 7	$10,000	+	$4,185	–	$0	=	$ 83,938
Year 8	$10,000	+	$5,036	–	$0	=	$ 98,974
Year 9	$10,000	+	$5,938	–	$0	=	$114,912
Year 10	$10,000	+	$6,895	–	$0	=	$131,807

If Jerry and Louise withdraw their entire IRA balance at the end of 10 years to pay for April's college education, they are not subject to the 10% early withdrawal penalty. They would have $31,807 of earnings subject to a 35% tax rate, or $11,132 total tax, leaving $120,675 ($131,807 – $11,132) of after-tax funds available to pay for their daughter's education.

Thus, even though the Kiddie Tax rules apply in Example #1, total after-tax money is $4,558 less in Example #2 (the difference between $125,233 and $120,675) because all the earnings are subject to the 35% tax rate rather than the excess over $2,100 of earnings under the Kiddie Tax rules. The only advantage then for Example #2 is that Jerry and Louise control the money and can prevent April from spending it on something other than her education.

Example: Jill is age 15 and wants to start saving for college. Her grandmother gave her $30,000 for her college fund. Jill's parents are in a 35% tax bracket. She puts the money into a savings account that earns $900 per year interest for the next three years. She gets a part-time job that pays $5,500 per year. Her parents also gift her $2,000 per year as an allowance. She does not save the allowance each year but spends it on herself. She makes a $5,500 IRA contribution each year from the money she earns at her W-2 job. The IRA account is a mutual fund that earns 6% each year.

Since her taxable income each year is zero, she pays no income tax. When she turns age 18 and is ready for college, she will have $50,210 of available funds for college, calculated as follows:

Savings account initial contribution	$30,000
Plus three years interest income	2,700
Plus three years of IRA contributions	16,500
Plus three years of earnings on her IRA	1,010
Total funds available	$50,210

If her parents choose not to claim Jill as a dependent for her first year of college (their income is too high for an education credit or deduction), Jill can cash in her IRA to pay for college (along with the rest of her savings) and will not be subject to any tax or a penalty (assume 2015 tax year rules apply).

IRA withdrawal	$17,510
Minus standard deduction	(1,050)
Equals taxable income	$16,460
Tax	$ 2,008
American Opportunity Credit	(2,008)
Tax after credit but before refundable portion of credit	$ 0

In this case, Jill receives the tax benefit of the American Opportunity Credit (AOC). The assumed 35% tax bracket for the parents means that they will not be able to receive any benefit from the AOC. Further, the benefit they receive for claiming Jill's personal exemption will either be eliminated or reduced by the personal exemption phase-out ranges. In this case, Jill will not be entitled to claim her own exemption because the parents are allowed to claim her.

Possible Risks

- If the timing of the IRA distribution is not right, and the distributed money is used to pay qualified education expenses for the student for a year following the year the money was distributed, the exception to the 10% penalty will not apply.
- Even though the 10% penalty for early withdrawal from an IRA may not apply, the distribution is still taxable. If the taxpayer does not qualify for an education credit or deduction to offset tax on the distribution, the taxpayer is using after-tax money to pay for the expenses. Other planning strategies that use pre-tax funds to pay for

college may be more appealing due to greater potential for tax savings.

Court Cases

Court Case: The IRS determined the taxpayer owed the 10% penalty on an early distribution from a qualified retirement plan [her 401(k) plan]. The taxpayer terminated her employment in 1996 but kept her 401(k) funds invested with her former employer's retirement plan. Several years later, she began graduate studies to obtain a permanent teaching certificate. Her former employer informed her that she was eligible to "roll over" her account balance to another qualified plan or IRA.

On the basis of research she did using the 2001 version of U.S. Master Tax Guide (published by Commerce Clearing House, Inc., a private commercial publisher), she decided to take a direct distribution of $40,457 from the 401(k) plan in 2001 to fund her education costs. At the time of the distribution, she had not reached 55 years of age, nor was she disabled. She reported the distribution on her tax return as income, but did not show that it was subject to the 10% early withdrawal penalty (she used the IRA distributions exception for higher education expenses on Form 5329).

The IRS said the qualified retirement plan in question was not an IRA, and that the 10% early withdrawal penalty cannot be avoided by using the distribution to pay for qualified education expenses. The taxpayer filed a petition with the court that said: "I used an early distribution from a qualified plan for educational expenses. I was forced to make a decision, by my employer, and I thought I interpreted the tax code correctly. The monies that I used were entirely my contributions. I was told that had I rolled them over for "one day," they would be exempt from the penalty. I feel I am being penalized (harshly) for such a finite misinterpretation. I would greatly appreciate a favorable ruling."

The court ruled that information from the Master Tax Guide is not an authoritative source. Congress intended the exception to apply only to IRA distributions and not to qualified retirement plan distributions. In ruling that the distribution was subject to the penalty, the court said: "...we think it appropriate to observe that we found petitioners to be very conscientious taxpayers who obviously take their federal tax responsibilities quite seriously. We recognize that the difference between a qualified retirement plan and an IRA is highly technical, and we applaud petitioners for their efforts in researching the tax consequences of receiving a 401(k) plan distribution. The Tax Court, however, is a court of limited jurisdiction and lacks general equitable powers." *(Domanico,* T.C. Summary Opinion 2006-55, April 19, 2006)

✎ **Author's Comment:** If the taxpayer, above, first rolled the 401(k) into an IRA, then the distribution from the IRA to pay higher education expenses would not be subject to the 10% early withdrawal penalty.

Court Case: The taxpayer received an early distribution from an IRA and used the funds to pay for his daughter's computer, which was used by her while attending classes at Miami University in Oxford, Ohio. The IRS said the cost of the computer was not a qualified higher education expense because it was not required by the university.

The court noted that neither the Internal Revenue Code nor the applicable regulations provide specific guidance on whether a computer is a qualified higher education expense (for purposes of the exception to the 10% early withdrawal penalty). However, according to IRC section 529(e)(3), a computer must be required in order to be a qualified educational expense, and no documentation from the university was presented in court that said the student must purchase a computer. The taxpayer contended that only four or five computers for 15,000 students were available at any time. He also said by having his daughter own a computer, she would not have to use the library computers and risk walking from the library back to her dorm room late at night.

In ruling that the computer was not a qualified higher education expense, the court said the daughter was not enrolled in any courses that specifically required her to have her own computer. No matter how necessary the taxpayer thought having her own computer may be, the expense of one was not required for her enrollment or attendance at the university and is not a qualified higher education expense for purposes of avoiding the 10% early withdrawal penalty. *(Gorski,* T.C. Summary Opinion 2005-112, August 4, 2005)

Court Case: In 2002, the taxpayer withdrew money from her IRA. She planned to use the money for college expenses. However, she did not enroll in college until 2003. IRC section 72(t)(2)(E) says the 10% penalty for early distribution from an IRA does not apply to distributions to the extent the distributions are used for qualified higher education expenses of the taxpayer for the taxable year. The court noted that under the express language of the statute, the qualified higher education expenses must be incurred by the taxpayer in the taxable year of the distribution. There are no exceptions to this requirement. The distribution from her IRA was thus subject to the 10% early withdrawal penalty. *(Ambata,* T.C. Summary Opinion 2005-93, July 19, 2005)

Court Case: The taxpayer used a distribution from an annuity policy contract to pay for college expenses. The IRS said the distribution was subject to the 10% early withdrawal penalty. In court, the taxpayer said the higher education exception under IRC section 72(t)(2)(E) should apply to distributions from annuity contracts since the title of IRC section 72, "Annuities; Certain Proceeds of Endowment and Life Insurance Contracts," indicates that all of the section's provisions apply to

continued on next page

annuities. The court disagreed with the taxpayer. The court said the argument fails because it is well settled that the heading of a section does not limit the plain meaning of the text. The relevant text of IRC section 72(q)(2) is clear. Nothing in that text contains either an exception for higher education expenses, or a provision that the exception found in IRC section 72(t)(2)(E) applies to the 10% penalty under IRC section 72(q)(1). *(Lieber,* T.C. Summary Opinion 2009-34, March 16, 2009)

Saving for College Using a Roth IRA

Cross References

- Form 5329, *Additional Taxes on Qualified Plans (Including IRAs and Other Tax-Favored Accounts)*
- Pub. 970, *Tax Benefits for Education*

Tax Issue

When applying for financial aid, assets held in 529 plans, ESAs, and accounts held in the student's name are generally considered to be available for funding college expenses. In many situations, the accumulated money in these accounts is not enough to fund the cost and often disqualifies the student from some or all other types of financial aid.

Taxpayers generally have limited resources and allocating them to appropriate funding vehicles can have an immediate and future impact on financing the costs of college. Taxpayers with limited resources are faced with a choice: Do I fund my own retirement? Or, do I fund my child's education?

Applicable Tax Law

- Roth IRA limits for 2015:
  - Under age 50: $5,500
  - Age 50 or older: $6,500
- Roth IRA phaseouts for 2015:
  - Married Filing Jointly or Qualifying Widow(er): $183,000 to $193,000.
  - Single, Head of Household, or Married Filing Separately and did not live with spouse at any time during the year: $116,000 to $131,000.
  - Married Filing Separately and lived with spouse at any time during the year: $0 to $10,000.
- Withdrawals of contributions of a Roth IRA are tax free.
- Withdrawals of earnings from a Roth IRA are tax free if the Roth IRA has been held for five years, and it is due to:
  - The participant is over age 59½,
  - Death or disability of the participant, or
  - Qualified first-time homebuyer.
- Taxable withdrawals are not subject to the 10% early withdrawal penalty if an exception to the penalty applies. Higher education expenses for the taxpayer, taxpayer's spouse, or the taxpayer's children or grandchildren qualify for the exception to the 10% penalty.

Tax Planning Strategies

Many taxpayers have the dual problem of saving for their child's college education and their own retirement. In situations where it is not possible to do both, a Roth IRA can provide the taxpayer with flexibility. In applying for financial aid, assets in Roth IRAs are considered less available for college expenses and therefore the student may qualify for more financial aid. This will allow the taxpayers to retain their assets for retirement savings and still have the flexibility to assist their child if they choose.

Roth IRA vs. college savings plans. Coverdell education savings accounts (ESAs) and qualified tuition plans (529 plans) are savings plans set up to assist in saving money for education expenses. Both plans offer tax-deferred earnings and tax-free withdrawals if withdrawals are used for qualifying education expenses. However, assets in these accounts are considered available funds when determining financial aid eligibility. In addition, if the money isn't used for qualifying education expenses, withdrawals of earnings will be taxed and a 10% penalty will be assessed unless an exception occurs. Contributions to an ESA are limited to $2,000 per year per beneficiary. Unless the beneficiary has special needs, the account balance on an ESA must be distributed in full at age 30.

With a Roth IRA, the taxpayer can contribute more than an ESA allows. The assets are considered less available for education purposes because they are in the parents' retirement accounts. In addition, there are no forced withdrawals from Roth IRAs.

Examples

Oscar and Maria, both age 42, plan for college funding for their daughter, Lilly, age 10. Oscar and Maria have a combined AGI of $90,000. They put $5,500 each into Roth IRAs for eight years. Assume 5% growth on each account. At the end of eight years, each Roth IRA is worth $55,146. When Lilly applies for financial aid, the assets in the Roth IRA will not be considered available.

Oscar and Maria can each withdraw $44,000 (eight years of $5,500 contributions) and not pay any taxes on the withdrawals. In addition, the earnings on each account of $11,146 can be withdrawn to pay for Lilly's college expenses. Although the earnings will be taxed, because it is used for qualified education expenses, there will not be a 10% penalty assessed.

If Lilly qualifies for scholarships or financial aid, and no money is needed from the Roth IRAs, the money can be left in the accounts to accumulate for Oscar and Maria's retirement.

✎ **Author's Comment:** Saving for college using a Roth IRA can prove to be beneficial for financial aid purposes. This is especially true when parents have limited funds. Roth IRAs can serve several purposes, namely having funds for retirement, withdrawals to pay education expenses, and as a source of emergency funds. By withdrawing the contributions first, the earnings can be left in the account to grow for a future benefit.

Possible Risks

- Non-taxable distributions from a Roth IRA are indicated on the parents' untaxed income section of the Free Application for Federal Student Aid (FAFSA) so a distribution is considered in the calculation as income for determining financial aid.
- Withdrawals of earnings are taxable. Even though an exception to the 10% penalty may apply, the taxpayer needs to take into consideration the taxes payable on the distribution of earnings from a Roth IRA.
- To qualify for the exception to the 10% penalty, distribution of the earnings must be taken in the year the qualifying expense occurs.
- Taxpayers always risk not having enough money for retirement by removing money from a Roth IRA.

Saving for College Using U.S. Government Savings Bonds

Cross References

- Form 8818, *Optional Form to Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989*
- Pub. 550, *Investment Income and Expenses*
- Pub. 970, *Tax Benefits for Education*

Tax Issue

In order to save for a child's education, many parents have transferred assets into a child's name to take advantage of the child's lower tax rate. However, if the child's education account generates over a certain amount of income for the year ($2,100 for 2015), the "Kiddie Tax" rules will apply, meaning that part of the child's income will be taxed at the parents' rate instead of the child's tax rate. There is also a danger of transferring assets to a child because the child could decide to use money intended for college on something else once the child turns the age of majority. Parents may need to consider other tax-advantaged alternatives for saving for college than simply transferring money to a child.

Applicable Tax Law

- When a child is subject to Kiddie Tax, the child's unearned income over $2,100 (2015) is taxed at the parents' marginal tax rate if that rate is higher than the child's. The Kiddie Tax rules apply when the child is:
  1) Under age 18 at the end of the year,
  2) Age 18 at the end of the year, and the child did not provide more than half of his or her support with earned income,
  3) A student, age 19–23 at the end of the year, and the child did not provide more than half of his or her support with earned income.
- Interest income earned on U.S. Savings Bonds does not need to be reported until the bond is redeemed.
- Interest on qualified savings bonds (Series EE bonds issued after 1989 and Series I bonds) may be excluded from income if the income is used for qualified college education expenses.
  1) The bond must be purchased by someone over age 24 and issued in the parent's name (not the child's),
  2) The proceeds must be used for tuition and fees (room and board is not included),
  3) If part of the proceeds from the redemption (interest and principal) are not used for qualified expenses, that amount is not excluded,
  4) The exclusion is phased out at modified AGI between $77,200 and $92,200 ($115,750 and $145,750 for Married Filing Jointly) for 2015.
- The annual purchase limit for electronically purchased Series EE and Series I savings bonds is $10,000 per individual for each series. The annual individual limit for paper Series I savings bonds purchased through IRS tax refunds is $5,000. There is no cumulative limit on the value of savings bonds that can be held by an individual.

Tax Planning Strategies

Low- and middle-income parents can help pay for college expenses using pre-tax earnings from U.S. Savings Bonds. U.S. Series EE savings bonds issued from May 2015 through October 2015 earn a fixed rate of 0.30%. U.S. Series I savings bonds bought from May 2015 through October 2015 earn zero percent. Taxpayers postpone reporting the interest until the bond is redeemed. Taxpayers may then be able to exclude part or all of the interest income from Series EE and Series I savings bonds redeemed in the same year the bond proceeds are used to pay for qualified higher education expenses.

Note: A new interest rate is declared on newly issued bonds every six months. Taxpayers who hold bonds issued during times of higher interest rates will see a greater benefit than the one illustrated in the following examples.

Examples

Example #1: Vic and Darlene decide to each purchase $10,000 per year in U.S. Series I savings bonds for the next 10 years to help fund their daughter's college education. Assume the bonds earn 1.94% annual interest. Assume their AGI in the year their daughter goes to college is below the phase-out amount. They do not receive a tax deduction for the purchase of the bonds, but after 10 years of savings, the interest earned is tax free, assuming all of the bonds are used for qualified education expenses. Their savings will grow as follows.

	Combined Bond Purchases		*Earnings*		*Taxes*		*End Balance*
Year 1	$20,000	+	$0	–	$0	=	$20,000
Year 2	$20,000	+	$388	–	$0	=	$40,388
Year 3	$20,000	+	$784	–	$0	=	$61,172
Year 4	$20,000	+	$1,187	–	$0	=	$82,358
Year 5	$20,000	+	$1,598	–	$0	=	$103,956
Year 6	$20,000	+	$2,017	–	$0	=	$125,973
Year 7	$20,000	+	$2,444	–	$0	=	$148,417
Year 8	$20,000	+	$2,879	–	$0	=	$171,296
Year 9	$20,000	+	$3,323	–	$0	=	$194,619
Year 10	$20,000	+	$3,776	–	$0	=	$218,395

Example #2: Assume the same facts as Example #1, except that Vic and Darlene decide to give their daughter $20,000 per year for the next 10 years to help their daughter save for college. Assume their daughter earns 1.94% annual interest on her savings. Assume Vic and Darlene are in the 25% tax bracket each year. Assume their daughter has no other income and Kiddie Tax rules apply. Their daughter's savings will grow as follows:

	Gift to Daughter		*Earnings*		*Taxes*		*End Balance*
Year 1	$20,000	+	$0	–	$0	=	$20,000
Year 2	$20,000	+	$388	–	$0	=	$40,388
Year 3	$20,000	+	$784	–	$0	=	$61,172
Year 4	$20,000	+	$1,187	–	$14	=	$82,345
Year 5	$20,000	+	$1,597	–	$55	=	$103,887
Year 6	$20,000	+	$2,015	–	$97	=	$125,806
Year 7	$20,000	+	$2,441	–	$190	=	$148,057
Year 8	$20,000	+	$2,872	–	$298	=	$170,631
Year 9	$20,000	+	$3,310	–	$408	=	$193,534
Year 10	$20,000	+	$3,755	–	$519	=	$216,769

The difference between Examples #1 and #2 illustrates that the tax-free earnings from U.S. government savings bonds will provide a greater return than a Kiddie Tax situation when the interest rate is identical. Plus, the U.S. government savings bond option allows the parents to control how the funds are to be used.

Possible Risks

- Because of the annual purchase limit on U.S. Savings Bonds, it may take many years to accumulate enough U.S. Savings Bonds to make a meaningful difference in tax. Thus, this strategy at best is a supplement to other college savings plans.
- Interest income on U.S. Savings Bonds may be too low for some taxpayers who are willing to take greater risks for greater rates of return.

- The AGI limitations on the exclusion could eliminate the tax benefit if the parents' income is too high in the year the bonds are cashed in to help pay for college.
- The exclusion does not apply to bonds purchased in the child's name.

Saving for College Using Life Insurance

Cross References

- Form 5329, *Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts*
- IRC §1035, *Certain exchanges of insurance policies*
- IRC §7702A, *Modified endowment contract defined*

Tax Issue

College savings plans such as Qualified Tuition Plans (529 plans), Education Savings Accounts (ESAs), UGMA and UTMA accounts, and savings bonds provide unique tax advantages for funding the cost of a college education. Earnings on 529 plans and ESAs grow tax deferred. Distributions from 529 plans and ESAs for qualifying education expenses are tax free. Earnings on UGMA and UTMA accounts are taxed at the child's rate, generally more favorably than the rate of the adult who gifted or transferred the money. The child, when reaching the age of majority, becomes the unconditional owner of the asset. Savings bond interest, when used for qualifying college expenses, is tax free for qualifying taxpayers.

The issues for college funding go beyond the taxation of the various funding choices that exist. Families need to consider all the factors, including financial aid availability, scholarships, student loan eligibility, and work-study programs. Many of the qualifications for these financial aid options are based on financial need of the student. When applying for financial aid, assets held in 529 plans, ESAs, and accounts held in the student's name are generally considered to be available for funding college expenses. In many situations, the accumulated money in these accounts is not enough to fund the cost and often disqualifies the student from some or all other types of financial aid.

Beyond the taxation and financial aid considerations, the largest obstacle for funding the savings vehicles is having the money to fund them. Taxpayers generally have limited resources and allocating them to appropriate funding vehicles can have an immediate and future impact on financing the costs of college. Taxpayers with limited resources are faced with a choice: Do I fund my own retirement? Or, do I fund my child's education? Also, if a family has limited resources, the death of the breadwinner can abruptly end any college savings plans in place.

Applicable Tax Law

- Gain on investment value within a permanent life insurance policy is not taxed as long as the gain is left within the policy.
- Death benefits on a life insurance policy are generally paid to the beneficiary free from income tax.
- Loans from contracts that are not Modified Endowment Contracts (MEC) can be taken from the policy tax free.
- Distributions of taxable amounts from a MEC are taxable at the time withdrawn. This is true whether the distribution is a withdrawal or a loan.
- Cash value in a life insurance policy can be transferred to another life insurance policy or an annuity tax free through an IRC section 1035 exchange.

Tax Planning Strategies

Permanent life insurance can be used as a planning tool for college expenses. If structured properly, a permanent life insurance contract provides for tax-deferred earnings and tax-free withdrawals by taking a loan against the cash value. In addition, permanent life insurance provides a tool to assist a taxpayer in financial aid planning.

Self-completing plan. A problem with traditional college funding plans is that they do not continue to fund themselves if the taxpayer who is contributing to them dies. The funding for a 529 plan for a 4-year-old ends when the breadwinner dies. With life insurance, the plan is self-completing. The breadwinner has the policy placed on his or her life. If he or she dies, the death proceeds provide for the future college funds for the surviving child.

Tax-free death benefit. Generally, death benefits paid to a beneficiary from a life insurance policy are tax free to the beneficiary.

Cash value. Permanent life insurance has a cash value that accrues within the policy as the policy stays in force. The cash value is determined by many factors, including the internal costs of the policy, the amount of money contributed to the policy, the age, gender and health of the insured, and the amount of death benefit selected. On some policies, the amount of insurance can increase as the cash value increases. These policies may have a higher internal cost structure as they are effectively providing more insurance.

Policy withdrawals. The cash value of a life insurance policy can be withdrawn or borrowed against. Amounts above the basis (premiums contributed) are generally taxable and subject to a 10% penalty unless the policyowner is older than 59½, disabled, or taking the withdrawal as part of a substantially equal periodic payment. Loans can also be taken from the policy.

Modified Endowment Contract (MEC). The federal tax law definition of life insurance limits the policyowner's ability to pay certain high levels of premiums. In addition, if the cumulative premium payments exceed certain amounts specified under IRC section 7702A (the 7-pay test), the policy will become a Modified Endowment Contract (MEC). The contract will fail the 7-pay test guidelines if the cumulative amount paid in during the first seven years of the contract exceeds the net level premiums as provided for by the policy. The death benefit of a MEC continues to be tax free. However, withdrawals or loans of cash value are taxable to the extent they exceed the basis in the policy.

Non-MEC. Cash values of a life insurance contract in which premium payment amounts are within the 7-pay guidelines of IRC section 7702A offer some additional benefits. Loans taken from non-MEC contracts are tax free to the policyholder. The amount needed for the 7-pay test is determined at the time the life insurance contract is issued by the insurer. The amount depends on several factors, including the insurance amount, the age, gender and health of the insured, and the type of policy issued. By using a non-MEC life insurance contract, a taxpayer can borrow against the cash value of the policy tax free.

Financial aid planning. Life insurance cash values are generally not considered an asset when needs-based financial aid is being determined. With assets in a life insurance policy, a student may be eligible for financial aid that he or she would otherwise not be eligible for if the assets are in some other asset category.

Examples

Example: Jim and Mary, both age 40, want to plan for college funding for their daughter, Emily, age 6. Jim and Mary have enough life insurance to pay the mortgage and provide income for the surviving spouse should one of them die. However, they do not have adequate insurance or assets to contribute to Emily's college expenses if either of them dies before she has finished college. They determine they need an additional $100,000 of life insurance to ensure funds for Emily's college if either of them dies.

Term insurance and 529 plan. Jim and Mary review the option of buying term life insurance and investing the difference in a 529 plan for Emily. The benefits of this plan include tax-deferred growth on the 529 plan and insurance proceeds to fund the college costs if the parent dies.

Permanent life insurance. Instead of buying a term life insurance policy and investing the difference in a 529 plan, Jim and Mary review the option of purchasing a permanent life insurance policy using the 7-pay feature to prevent the policy from becoming a MEC.

continued on next page

If they find they do not need the money when Emily goes to college, Jim and Mary can:

- Continue the policies as they exist,
- Maintain the tax-deferred status of the cash value of the insurance by using a section 1035 exchange to move the cash value to annuities,
- Take a loan or withdrawal for their own purposes (such as starting a business), or
- Cash in the policies and pay the appropriate taxes and penalties.

Comparing the plans. Jim and Mary compare a 7-pay permanent insurance plan with a term insurance plan, investing the additional amount into a 529 plan. For comparison, they allocate $4,000 per year to either plan. They get a term insurance premium quote of $200 for a 15-year term insurance policy. Using a $100,000 insurance policy on Jim's life, they find the following comparison.

	Term Insurance and 529 Plan	*Permanent Insurance*
Insurance premium	$200 per year for 15 years	$4,000 per year for 7 years
529 contributions	$3,800 per year for 7 years*	$0
Year 12 value (Emily at age 18)**	$40,000	$36,000
Amount considered available for college expenses for financial aid planning purposes	$40,000	$0

* The amounts illustrated are based on $4,000 contributed to either plan for years 1 through 7, for comparison purposes only. For years 8 through 12 (Emily will be age 18 on year 12), the term insurance plus 529 plan would only have $3,800 per year available to contribute to a 529 plan or other savings plan as the life insurance premium would need to continue to be paid. During years 8 through 12 for the permanent insurance plan, $4,000 would be available for some other savings plan, such as a 529 plan, as the insurance continues to be in force and does not require additional premiums. The $4,000 amount into the permanent insurance assumes the maximum amount the policy can receive without becoming a MEC.

** Values are estimated based on 4% interest rate and estimated internal insurance costs for the permanent life insurance plan. This is for illustrative purposes only as only a life insurance contract can guarantee the costs and values of the policy. See *Possible Risks,* next column.

With the term insurance and 529 plan, Emily might not be eligible for any need-based financial aid during the first few years in college. Because the 529 plan values are considered available for college costs, Jim and Mary may be forced to spend this money and not have other sources available. For example, the eligibility for some student loan programs is need based. With assets in a 529 plan, financial need becomes difficult to prove.

With the permanent insurance plan, Emily would be more likely to qualify for need-based financial aid. In addition, Jim and Mary could continue to maintain the cash value of the life insurance plan. They would have the option of taking a loan to help pay for Emily's college expenses or leaving the values intact and using other sources to fund her college expenses.

Conclusion: Saving for college using a permanent life insurance policy can prove to be beneficial for financial aid and accumulation purposes. The self-completion feature of using life insurance provides for the security of knowing funds will be available. The use of life insurance assists the taxpayer in managing financial aid eligibility. Policy loans can be used in place of, or in addition to, student loans.

Whether or not a taxpayer uses the permanent life insurance strategy to fund college savings, the need for some type of life insurance is a critical component in planning for college savings. The death of a breadwinner who is funding a 529 plan or ESA can put an abrupt end to the contributions into those accounts.

Possible Risks

- Withdrawals of earnings from life insurance contracts that qualify as an MEC are taxable to the owner of the policy. In addition, withdrawals of earnings by a policy owner who is under the age of 59½ may incur an additional 10% tax penalty.
- Permanent life insurance contracts contain several expenses which can lessen the growth inside a policy. Commissions, premium taxes, insurance costs, surrender charges, and administrative costs can be prohibitive in accumulating sufficient funds.
- Only an insurance contract can guarantee an insurance amount, premiums, and costs. No values, including those used in the examples, can be guaranteed by anything other than an insurance contract.
- Variable insurance contracts are exposed to market fluctuations. A taxpayer's risk tolerance should be evaluated thoroughly before using a variable life insurance policy as a funding vehicle for college savings.
- Insurance policies that are underfunded (not enough premium paid in to the policy) have the risk of not earning enough interest within the policy to fund the future expenses of the policy.
- If the costs of the policy diminish the amount left in a policy after a withdrawal or loan to the point where the policy can no longer stay in force, additional premiums may be required. If additional premiums are not added, the policy could terminate, or lapse, and the previously withdrawn or borrowed gain becomes taxable.
- A person applying for life insurance needs to be in good health at the time the policy is issued in order to keep the internal costs of the policy at a minimum. If the costs of the policy are too high, the cash value within the policy cannot grow as fast as if the costs are lower.

- Interest paid on life insurance policy loans do not qualify as a deduction from taxable income, whereas interest paid on student loans may qualify as a deduction from taxable income.
- If a policy is changed after it is issued, the 7-pay amount can change. A policy can inadvertently become a MEC by increasing or decreasing the insurance amount, or by changing a rider or owner on the policy.
- When comparing a 7-pay permanent insurance plan with a term insurance plan where the difference in the amounts is invested in a 529 plan, the death benefit value actually increases in later years with the term insurance plan. For example, after investing in a 529 plan for five years and keeping the term life insurance in force, the total value at the death of the insured is equal to the amount of the life insurance plus the 529 plan value. When comparing this to the permanent insurance, the total death value is only the insurance value.

Education Tax Credits—High-Income Parents

Cross References

- Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)*
- Pub. 970, *Tax Benefits for Education*

Tax Issue

Taxpayers who pay for qualified higher education expenses can reduce taxes by claiming an education tax credit in 2015. These tax benefits are limited by the taxpayer's modified adjusted gross income (AGI). Thus, a high-income taxpayer with AGI above the phase-out limits receives no tax benefit for paying the cost of higher education.

Applicable Tax Law

American Opportunity Credit:

- Qualified expenses include tuition, fees, and course materials, such as books, supplies, and equipment that are required for enrollment or attendance at an eligible educational institution.
- An eligible student must be enrolled at least half time in a degree program, must be in the first four years of higher education, and cannot have a felony drug conviction.
- The tax credit equals 100% of the first $2,000 of qualified expenses and 25% of the next $2,000. Up to 40% of the tax credit is refundable. The maximum benefit is $2,500 per student. There is no limit on the number of eligible students.
- The tax credit phases out in 2015 when the taxpayer's modified AGI is between $80,000–$90,000 for Single and HOH, and $160,000–$180,000 for MFJ.

Lifetime Learning Credit:

- Qualified expenses include tuition and fees required for enrollment or attendance at an eligible educational institution, including courses to acquire or improve job skills.
- An eligible student must be enrolled in one or more courses at an eligible educational institution (part-time students qualify—students beyond four years qualify).
- The tax credit equals 20% of qualified expenses up to $10,000. No part of the tax credit is refundable. The maximum benefit is $2,000 per taxpayer regardless of the number of eligible students.
- The tax credit phases out in 2015 when the taxpayer's modified AGI is between $55,000–$65,000 for Single and HOH, and $110,000–$130,000 for MFJ.

Tax Planning Strategies

Education credit. If the parent's modified AGI exceeds the limits for claiming a credit or deduction, the parent can choose not to claim an exemption for a dependent student. By choosing not to claim the student as a dependent, the student can then claim an education credit (either the American Opportunity Credit or the Lifetime Learning Credit). The student can also deduct any qualifying student loan interest paid. The dependent student is not entitled to claim his or her own exemption. The refundable portion of the American Opportunity Credit is not available to a dependent student.

This planning strategy works even if the parent (or grandparent or other third party) actually pays the educational expense. These payments are considered gifts to the student and then treated as if the student paid the expense for purposes of claiming the tax credit.

Examples

Example #1: Roger and Judy have a son, Dwayne, who is in his second year of college. For 2015, Roger and Judy paid $12,000 for Dwayne's college tuition. Roger and Judy's modified AGI for 2014 is $200,000. Dwayne earned $18,000 W-2 income working full time during the summer while on break from school and part time the rest of the year. Assume Roger and Judy have $60,000 in itemized deductions and Dwayne takes the standard deduction. Without implementing this tax planning strategy, their tax returns are calculated as follows:

Roger and Judy's Return:

AGI	$ 200,000
Minus itemized deductions	(60,000)
Minus personal exemptions ($4,000 × 3)	(12,000)
Taxable income	$ 128,000
Tax	23,588
Minus allowable education credits (not allowed if AGI is too high)	(0)
Tax after credits	$ 23,588

Dwayne's Return:

AGI	$ 18,000
Minus standard deduction	(6,300)
Minus personal exemption (not allowed for a dependent)	(0)
Taxable income	$ 11,700
Tax	1,294
Minus allowable education credits (not allowed if claimed as a dependent)	(0)
Tax after credits	$ 1,294

Combined family tax equals $24,882 ($23,588 + $1,294).

Example #2: Assume the same facts as Example #1, except that Roger and Judy choose not to claim an exemption for their dependent son, Dwayne. Their tax returns are calculated as follows:

Roger and Judy's Return:

AGI	$200,000
Minus itemized deductions	(60,000)
Minus personal exemptions ($4,000 × 2)	(8,000)
Taxable income	$132,000
Tax	24,588
Minus allowable education credits (not allowed if AGI is too high)	(0)
Tax after credits	$ 24,588

Dwayne's Return:

AGI	$ 18,000
Minus standard deduction	(6,300)
Minus personal exemption (not allowed for a dependent)	(0)
Taxable income	$ 11,700
Tax	1,294
Minus allowable education credits ($2,000 × 100%, limited by tax)	(1,294)
Tax after credits	$ 0

Combined family tax equals $24,588 ($24,588 + $0). Thus, combined family tax is $294 less ($24,882 – $24,588) by not claiming an exemption deduction for IDwayne.

Possible Risks

- The tax savings by a dependent student claiming a tax credit may not be as much as the tax savings by a parent claiming the student as a dependent. A comparison calculation must be made before deciding whether the parent should give up the dependency exemption in order to allow the student to claim the credit.
- Rather than having the parent give up the dependency exemption, the student's tax liability could be wiped out by having the parent gift money to the student so that the student can afford to make a traditional IRA contribution, which in turn wipes out the student's tax liability on earned income.
- The education credits/deduction are not available for those who use the MFS filing status.

Author's Comment: The personal exemption phase-out for high-income taxpayers did not apply for tax years 2011 and 2012. The full phaseout of the personal exemption applies for tax years after 2012. The motive for doing this tax planning strategy increases for high-income parents as they will receive reduced or no tax benefit for claiming the exemption for a dependent student.

Planning for Obtaining Financial Aid

Cross References

- Free Application for Federal Student Aid (FAFSA), www.fafsa.ed.gov
- Pub. 970, *Tax Benefits for Education*

Tax Issue

Individuals who want to attend college but cannot afford the costs outright must find alternative funding through various types of financial aid. Many factors affect eligibility for federal financial aid, therefore, all students should apply for financial aid every year even if they think they do not otherwise qualify.

Applicable Rules

FAFSA. The Free Application for Federal Student Aid (FAFSA) is the first step in the financial aid process. Students use the FAFSA to apply for federal student aid, such as grants, loans, and work-study. In addition, most states and colleges use information from the FAFSA to award non-federal aid.

The FAFSA must be submitted for each year the student wants financial aid.

The FAFSA can be completed online at www.fafsa.ed.gov. Students will first need a PIN in order to electronically sign their FAFSA forms, which can be obtained at www.pin.ed.gov.

Income tax return. If the student (or parents) needs to file a 2015 income tax return with the IRS, it is recommended that it is completed before filling out the FAFSA. A FAFSA can be submitted using estimated tax information, which can be corrected after the tax return is filed.

Expected Family Contribution. The questions on the FAFSA are required to calculate the student's Expected Family Contribution (EFC). The EFC measures the student's family's financial strength and is used to determine the student's eligibility for federal student aid. The EFC is split between an expected amount contributed from the student (usually more) and an expected amount being contributed from the parents. The student's state and the colleges listed may also use some of the responses to determine eligibility for school or state aid, in addition to federal aid.

Student Aid Report. A student's EFC will be listed on their Student Aid Report (SAR). The SAR summarizes the information submitted on the student's FAFSA. It is important for the student to review his or her SAR to make sure all the information is correct and complete. Make corrections or provide additional information, as necessary.

Financial need. Using the information on the student's FAFSA and his or her EFC, the financial aid office at their chosen college will determine the amount of aid the student will receive. The college will use the student's EFC to prepare a financial aid package to help meet financial need. Financial need is the difference between the EFC and the college's cost of attendance (which can include living expenses), as determined by the college.

Financial need can vary based on whether:
- More than one family member is enrolled in school,
- The student is an older student, or
- The family's main wage earner is unemployed.

Need analysis formula. To determine financial need, a need analysis formula measures the parents' and student's assets and income. Assets are measured as follows:
- Assets in the student's name are assessed at a maximum rate of 20%, whereas parents' assets are assessed at a maximum rate of 12%.
- The assets of other children are not considered by the need analysis formula.
- Specific types of property (automobiles, computers, furniture, books, clothing and school supplies, boats, and appliances) do not count as assets.
- Retirement funds and pensions are generally not considered assets.
- Annuities and life insurance policies are generally not considered assets.
- Small businesses owned and controlled by the student's family are excluded as assets.
- Consumer debt (such as a credit card balance) is not counted against assets and income.
- Only debt secured by property (mortgage on home or business loan for equipment) is counted against assets and income.

Parent's and student's income and assets are considered to determine financial need.

Untaxed benefits. Reports benefits that were not included in taxable income but which are counted during the need analysis process. These amounts will be added to taxable income. This includes the following:
- Earned Income Credit (EIC).
- Additional Child Tax Credit.
- Welfare benefits, including Temporary Assistance for Needy Families (TANF). Food stamps or subsidized housing are not included.
- Untaxed Social Security benefits.

Tax-deferred and untaxed income. Reports income that was not included in taxable income but which is counted during the need analysis process. These amounts will be added to taxable income. This includes the following:
- Contributions to tax-deferred pension and savings plans.
- IRA deductions and payments to SEP, SIMPLE, and Keogh plans.
- Child support received for all children. Foster care or adoption payments are not included.
- Tax-exempt interest income.
- Untaxed portions of IRA distributions and pensions, excluding rollovers.
- Housing, food, and living allowances paid to members of the military, clergy, and others.
- Veterans' noneducation benefits such as Disability, Death Pension, Dependency and Indemnity Compensation (DIC), and VA Educational Work-Study allowances.
- Any other untaxed income or benefits not reported elsewhere on Worksheets A or B, such as workers' compensation, untaxed portions of railroad retirement benefits, Black Lung Benefits, disability, and so on.

Student aid included in AGI. Reports certain types of taxable student aid income and credits that were included in AGI but which are not counted during the need analysis process. These amounts will be subtracted from taxable income, thereby increasing aid eligibility. This includes the following:
- Education credits (Hope Credit and Lifetime Learning Tax Credit).
- Child support paid because of divorce or separation.
- Taxable earnings from Federal Work-Study and other need-based work programs. Include the need-based employment portions of fellowships and assistantships.
- Other student grant and scholarship aid reported in adjusted gross income (AGI). This includes AmeriCorps awards (awards, living allowances, and interest accrual payments), as well as student grants and scholarships (only the amount that is taxable and was included in AGI, such as the amount in excess of qualified higher education expenses).

Business and investments defined for FAFSA purposes. The net worth of investments is the amount left over after deducting debt from the value of the investment. If multiple investments are owned, the total amount is reported as a lump sum. If the debt exceeds the value of the investments, then enter $0 as the value of the investments.

Investments include real estate (do not include the home the student lives in), trust funds, UGMA and UTMA accounts, money market funds, mutual funds, certificates of deposit, stocks, stock options, bonds, other securities, installment and land sale contracts (including mortgages held), commodities, etc.

Investments also include qualified educational benefits or education savings accounts (e.g., Coverdell savings accounts, 529 college savings plans and the refund value of 529 prepaid tuition plans). For a student who does not report parental information, the accounts owned by the student (and/or the student's spouse) are reported as student investments. For a student who must report parental information, the accounts are reported as parental investments, including all accounts owned by the student and all accounts owned by the parents for any member of the household.

Investments do not include the home the student lives in, the value of life insurance, retirement plans [401(k) plans, pension funds, annuities, non-education IRAs, Keogh plans, etc.].

Investments also do not include UGMA (Uniform Gifts to Minors Act) and UTMA (Uniform Transfers to Minors Act) accounts for which the student is the custodian, but not the owner.

Investment value means the current balance or market value of these investments as of the day the FAFSA is filled out.

Investment debt means only those debts that are related to the investments.

Business and/or investment farm value includes the market value of land, buildings, machinery, equipment, inventory, etc. Business and/or investment farm debt means only those debts for which the business or investment farm was used as collateral.

Business value does not include the value of a small business if the family owns and controls more than 50% of the business and the business has 100 or fewer full-time or full-time equivalent employees. For small business value, the family includes (1) persons directly related to the student, such as a parent, sister or cousin, or (2) persons who are or were related to the student by marriage, such as a spouse, stepparent, or sister-in-law.

Investment farm value does not include the value of a family farm that the student (spouse and/or parents) live on and operate.

Planning Strategies

The EFC is the amount of money the student's family will be expected to contribute to the student's education. The EFC amount is subtracted from the school's Cost of Attendance (COA) to arrive at the student's financial need. COA includes tuition, fees, room and board, books and supplies, travel, and personal and incidental expenses.

The lower a student's EFC, the more financial aid he or she will receive. More often than not, a student's EFC is high. This is because the need analysis formulas are heavily weighted toward current income and consider income and assets without taking credit card debt and automobile loans into consideration. Additionally, student income and assets can add significantly to the EFC figure.

Income Strategies:

- Avoid paying the student a salary from the family business.
- Avoid selling items that will produce a capital gain during the base year (first year of financial aid application) because capital gains are treated like income. If securities must be sold while the student is in college, wait until after April of their junior year, when the last financial aid application has already been filed for the student's senior year.
- Avoid taking money out of a retirement fund to pay for educational expenses. In general, retirement funds are not counted as an asset in the need analysis formula. However, if distributions are made, this converts a sheltered asset into an included asset. Therefore, it is more beneficial to spend down cash in a bank account first.
- Reduce parents' income to increase eligibility for financial aid when parents' AGI is close to $50,000. If the parents' AGI is under $50,000, then the family may qualify for the Simplified Needs Test (SNT) which disregards assets when determining the EFC. Some methods include:
  - –Taking unpaid time off.
  - –Postponing bonuses until after the base year.
  - –Reducing salaries of family members in a family run C corporation business (income retained by the corporation is considered a business asset, but assets are treated more favorably than income).
  - –Increasing contributions to retirement funds (SNT depends only on AGI, not income).

Asset Strategies:

- Avoid saving money in the student's name. Assets should be saved in the parents' name because parents' assets are assessed at a much lower rate for determining need (12% for parent versus 20% for student).

- A section 529 college savings plan saved in the parents' name has minimal impact on financial aid eligibility, and one owned by a grandparent has no impact on the student's eligibility.

- Spending down the student's assets, preferably within the first year, before using any parent asset will leave the family with the most money left over after graduation.
- Put parent assets in the name of another sibling not in college because assets of other children are not considered by the need analysis formula.
- Buy necessary purchases prior to applying for financial aid. Specific types of property (automobiles, computers, furniture, books, clothing and school supplies, boats, and appliances) do not count as assets. Therefore, if a student will need a vehicle or computer, it is best to spend the student's money to purchase necessary items prior to entering college.
- Grandparents who wish to pay for college should pay money directly to the school to avoid increasing parental or student assets by giving money to them outright. Or, if the grandparents wait until the child has graduated, they could pay off the student loans instead.
- Make maximum contributions to retirement funds because these assets are not considered by the need-based formula.
- Buy life insurance policies or tax-deferred annuities because these assets are not considered by the need-based formula.

Consumer debt. Credit card debt and automobile loans are not considered against assets and income in the need-based formula. Therefore, paying off credit card debt and automobile loans will increase eligibility for financial aid by reducing available cash.

Mortgage debt. To maximize eligibility for financial aid, reduce cash and other assets by prepaying mortgage debt. In addition, parents could take out a home equity line of credit each year to pay for the student's school expenses. Interest payments would be tax deductible and the loan would reduce assets considered by the need-based formula.

Change in financial circumstances. A student should contact his or her financial aid office if the student or his or her family has unusual circumstances that should be taken into account in determining financial need. Some examples of unusual circumstances are unusual medical or dental expenses or a large change in income from last year to this year.

Non-federal assistance. Information about other non-federal assistance may be available from foundations, religious organizations, community organizations, and civic groups, as well as organizations related to a student's field of interest, such as the American Medical Association or American Bar Association. Check with parents' employers or unions to see if they award scholarships or have tuition payment plans.

Independent status. If a student is considered an independent, he or she does not have to include any parental income or assets on the FAFSA application. A student is considered an independent if he or she:

- Gets married before submitting the FAFSA.
- Attains age 24.

Useful websites:

College Navigator. http://nces.ed.gov/collegenavigator/ Search colleges and their costs for different degree programs.

Deadlines. www.fafsa.ed.gov/deadlines.htm
Each state has a deadline for submitting a financial aid application, depending on what school year the student is attending.

Expected Family Contribution (EFC) Calculator. www.finaid.org/calculators/finaidestimate.phtml
The calculator can estimate EFC and financial aid based on input of income and assets of both the parents and student.

Examples

Example: Kendra's grandparents want to help pay for her college expenses. Rather than giving her cash outright, her grandparents purchase a new laptop computer for Kendra and pay for her room and board while she lives in a residence hall. Therefore, Kendra's grandparents' assistance does not affect her financial aid eligibility because they have not increased her assets or income. Alternatively, Kendra's grandparents could have been saving money in a section 529 plan and Kendra could use this money for tuition and expenses without affecting her financial aid eligibility because the plan is owned by her grandparents.

Example: Warren is age 21 and a senior in college. Last year he made enough income not to be claimed by his parents on their tax return. For FAFSA purposes, however, Warren is not considered an independent and must include his parents' income and asset information on his application.

Example: Jill has saved up a college fund of $30,000 in her name and her parents have $60,000 saved for her college expenses. In Jill's freshman year, her school calculated an EFC of $13,200, with $6,000 from Jill and $7,200 from her parents. (Assume the parents have $110,000 in assets above the need-based formula allowance.) Jill should spend from her assets as soon as possible to maximize the family assets upon her graduation as illustrated on page 2-20.

Option #1: Jill and her parents spend funds according to EFC analysis.

Year	*Jill's College Fund*	*Parents' College Fund*
Freshman	$30,000 – $6,000 = $24,000	$60,000 – $7,200 = $52,800
Sophomore	$24,000 – $4,800 = $19,200	$52,800 – $6,336 = $46,464
Junior	$19,200 – $3,840 = $15,360	$46,464 – $5,576 = $40,888
Senior	$15,360 – $3,072 = $12,288	$40,888 – $4,907 = $35,981
Remainder	$12,288	$35,981

This option yields a total of $48,269 in family assets left over when Jill graduates.

Option #2: Jill's parents' college fund is spent before Jill's college fund.

Year	*Jill's College Fund*	*Parents' College Fund*
Freshman	$30,000 – $0 = $30,000	$60,000 – $7,200 – $6,000 = $46,800
Sophomore		$46,800 – $5,616 – $6,000 = $35,184
Junior		$35,184 – $4,222 – $6,000 = $24,962
Senior		$24,962 – $2,995 – $6,000 = $15,967
Remainder	$30,000	$15,967

This option yields a total of $45,967 in family assets left over when Jill graduates.

Option #3: Jill's college fund is spent before her parents' college fund.

Year	*Jill's College Fund*	*Parents' College Fund*
Freshman	$30,000 – $6,000 – $7,200 = $16,800	$60,000 – $0 = $60,000
Sophomore	$16,800 – $3,360 – $7,200 = $6,240	$60,000 – $0 = $60,000
Junior	$6,240 – $1,248 – $4,992 = $0	$60,000 – $2,208 = $57,792
Senior	$0	$57,792 – $6,935 = $50,857
Remainder	$0	$50,857

This option yields a total of $50,857 in family assets left over when Jill graduates.

This is a simplified example illustrating the benefit of spending the student's assets first. Actual calculations are based on numerous factors including age, income, and assets.

Possible Risks

- **Assets in student's name.** Parents cannot just transfer an asset back to their name as the student nears college age because the asset legally belongs to the child and the IRS could assess back taxes and penalties as well.
- **Reducing salary from family business.** A parent who reduces their salary from their C corporation family business may run the risk of the IRS asserting they are not paying themselves reasonable wages.
- **Trust funds.** Generally, trusts can harm the student's eligibility for financial aid if the fund is set up to prevent the trustee from spending principal. The need-based formula assesses a trust as a student asset, regardless of any restrictions placed on principal. Therefore, this type of asset will only increase the student's expected contribution each year.
- **Retirement funds.** During the base year, any pre-tax contributions to retirement funds are not sheltered because the need analysis formula counts these contributions as untaxed income. However, it is still beneficial to make contributions because the money will thus be sheltered during later years.
- **Consumer debt.** It is not beneficial to use credit cards to pay for college because having high amounts of consumer debt does not count against the assets when determining financial need.
- **Independent status.** Being declared an independent for financial aid purposes does not always lead to an increase in eligibility for financial aid. The parents' income and assets are not considered by the need-based formula, but a student who gets married will need to include the financial information of his or her spouse. Additionally, parents sometimes make the mistake that if a student is not claimed as a dependent on their tax return that the student is an independent for financial aid purposes. Therefore, even if the student is self-supporting does not necessarily mean he or she qualifies as an independent student.

~ End ~