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Lower the cost of saving for education

By Steven Podnos, MD, MBA, CFP

These tax tools can make it easier to pay for your children's and grandchildren's schooling.

Other than your home, your largest lifetime expense may well be paying for your children's or grandchildren's educations. Total expenses to educate one child in private school from kindergarten through college easily can reach $500,000. Most of us pay these expenses with after-tax money, so you must earn at least 35% more than this amount to have the funds needed.

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Fortunately, several tax-advantaged techniques are available to pay some or all of your children's educational expenses. Using these techniques can lower your total bill by up to one third in some cases.

Financial planning for the costs of education is a highly individual process. Each family has unique expected costs, incomes, savings, and tax brackets. Consulting a financial adviser is almost always highly cost-effective, and the farther in advance, the better.

This article will look at the technique of income shifting as way to lower the cost of education, examine the most tax-effective alternate methods to save for educational costs, discuss the use of tax credits when the child reaches college age, and identify strategies that you should avoid.

THE IMPORTANCE OF THE 'KIDDIE TAX'

Some doctors' families prefer not to segregate funds for their children's educations. Instead, they keep control of the funds and disperse them as needed. However, they incur a tax cost by doing so, because having at least some of the funds in the child's name, and using other tax-favored techniques, usually saves money year after year.

The concept of income shifting relies on the fact that your children are in a lower tax bracket than you. This is true for earned income at any age, and for some unearned income (income derived from sources such as interest, dividends, and capital gains).

Understanding the "kiddie tax" is important when developing an income-shifting strategy. This tax regulation currently states that unearned income of more than $1,900 per year is taxed at the parents' marginal tax bracket rate for:

- children under age 19 whether or not they are students, and
- children up to age 24 who are full-time students but who are not married and filing a joint return.

Students older than 19 who are supplying more than one-half of their annual expenses personally are not subject to the kiddie tax.

If your children are subject to the kiddie tax, then limiting their unearned income to $1,900 or less makes sense. If they are not subject to the tax, then shifting even more unearned income to them may make sense. Why? Most of you reading this article have income from wages and interest taxed at a 35% rate and capital gains (and some

dividends) taxed at 15%. Your children's rates are likely to be at or less than 15% for *earned* income. If your child is a student and has not yet reached his or her 24th birthday, then *unearned* income less than $1,900 is taxed at a blended rate at or below 5%. If the child is a student older than 23, or younger than 23 and not a dependent, then unearned income over $1,900 is taxed at much lower rates than what you pay.

INCOME SHIFTING

You can shift income to your children in two ways. The first method is applicable only if you control a business. You may hire a child to work in your practice (or other business, if you own one) in an age- and task-appropriate method. Keep records of the work time and complexity of the task(s), and pay the child an appropriate salary. All payments for work are tax-deductible as ordinary expenses to your business. If your business is incorporated or if the child is older than 18, then Social Security and Medicare taxes are due on the amounts paid to the child.

Anyone may earn up to $5,800 per year in 2012 without any income tax due because of the standard deduction. This amount is regardless of any unearned income received. For a single child, income up to approximately $8,700 yearly is taxed at a 10% rate. Even income up to $35,350 is taxed only at a 15% rate. All of these tax brackets are lower than what yours would be if you paid yourself the money in the form of wages or a corporate dividend.

For example, consider paying an older child up to $10,800 per year. The child can open a traditional individual retirement account (IRA) and fund it up to $5,000 per year. Doing so lowers his or her earned income back to the untaxed $5,800 level. The money in the IRA grows tax-free until age 70 or can be withdrawn to pay for college or graduate school.

If funds are withdrawn for educational expenses, tax will be due on the entire amount withdrawn, but the child probably will be in a very low tax bracket during those years, and penalties for the early withdrawal of IRA savings are waived if the money is used for educational costs.

Another alternative strategy is to fund a Roth IRA with $5,000 annually. Doing so will cause the amounts earned over $5,800 to be taxed at the child's 10% tax bracket (usually). The Roth contributions can be withdrawn as desired with no penalties anytime thereafter (although earnings should be left in the account until age 59 ½ to avoid paying an early withdrawal penalty.)

When the child starts college, tax credits may be available to minimize or eliminate taxation due to the student's earned income. Two such educational tax credits are available for families with adjusted gross incomes at or less than the $120,000-to-$180,000 range. If this applies to your situation, ask about the American Opportunity and Lifetime Learning Tax Credits (see the IRS Web site www.irs.gov/individuals/article/0,,id=121452,00.html). They may be useful for children who are students but not considered dependents. Note that the Lifetime Learning tax credit also is available to student in graduate school.

USING GIFTS TO SHIFT INCOME

If you sell investments that have appreciated, you will pay ordinary income tax (up to 35%) on those investments held for less than 1 year. Longer-term investments will be taxed at lower rates, sometimes as low as 15%. If, instead, you give appreciated investments to a child, then the child can sell the asset and pay tax in an even lower bracket. Any individual may give any other individual up to $13,000 per year without any gift tax consequences. Keep this in mind for all extended relatives.

Gifts also can be invested in a custodial account (often called a Uniform Gift to Minors Act [UGMA] or Uniform Transfers to Minors Act [UTMA] account) or individual account for non-minor children for the purpose of generating income and capital gains that are taxed at a lower rate than the parents' bracket. Note, however, that this strategy will impair the child's ability to qualify for need-based financial aid.

Under the kiddie tax, your child can receive up to $1,900 annually in unearned income and pay no more than 5% tax on this income. The income can be from the sale of gifted assets and/or income generated by funds held in a custodial UTMA account. I encourage clients to fund custodial accounts as early as possible in their child's life to take advantage of the lower rates.

Until the child is age 24 (if still a student), the selection of investments that generate unearned income and the

capital gains from sales of gifted assets can be managed to minimize taxes. After age 24 or after the child finishes school (whichever comes first), this management becomes less important. Remember that funds transferred into a UTMA account are legally owned by the child and accessible at age 18 without your permission. Also note that any custodial funds will be counted on a 20% basis for determining financial aid (for example, if the child has $40,000 in a custodial account, colleges would expect the child to contribute at least $8,000 per year from the funds in that account).

When the child reaches college age, tax credits can be used to minimize or eliminate taxes on investment income or the sale of gifted assets.

EXAMPLES OF SAVINGS THROUGH INCOME SHIFTING

If your student's college expenses are $20,000 per year: You must earn $30,000 before taxes to have the $20,000 needed to pay the child's expenses (a $10,000 tax cost). Or you may mix earned income with capital gains from selling an appreciated asset in a 15% long-term capital gain bracket. For example, say you earned $5,000 during the year and sold an investment that had appreciated in value by $20,000. The capital gains tax on the investment would be 15%, or $3,000, and the tax on the wages would be 35%, or approximately $1,800. That would leave you with about $20,200 for your child's education for the year, and you would lose $4,800 to taxes.

Alternatively, if you were to pay the child the same $5,000 wage and gift the appreciated asset to be sold in the child's tax bracket, the tax essentially would be $0 on the wages (because the standard deduction of $5,850 would make the income nontaxable) and about $1,100 on the capital gain in the child's lower tax bracket. All told, by using income shifting, you would save $3,000 to $4,000 per year in tax costs compared with just earning the money needed.

If your student's graduate school expenses are $30,000 per year: You would have to earn $45,000 before taxes to have the $30,000 cost of a year of graduate school, for a tax cost of $15,000. Instead, pay the child $20,000 for work during the summer and on some breaks from school, and gift an appreciated asset with long-term capital gains of $10,000 to be sold in the child's tax bracket.

The tax under this scenario would be approximately $1,500 based on an adjusted gross income of $10,400 (after the child uses the personal exemption of $3,800 and standard deduction of $5,800). The capital gains tax in the child's lower tax bracket would be $1,000, resulting in a total tax to the child of $2,500. If the child had no other earned income or was not subject to the kiddie tax, then all of the capital gain may avoid taxation. Thanks to income shifting, you have saved between $10,000 and $15,000 for the year.

AFTER-TAX WAYS TO FUND EDUCATION

The following methods of funding educational costs involve using money that already has been taxed. I recommend them because they still offer advantages compared with paying these costs out of fully taxable current savings or income:

529 plans So-called 529 plans are state-sponsored education expense plans that are open to anyone, even residents of other states. They have no cap on income and liberal caps on contributions. They are funded with after-tax money, although many states offer a credit against state taxes. The earnings on these plans are not taxed as long as the funds are used toward education costs.

The 529 plans come in two varieties: a prepaid tuition plan and a college savings plan. Under a prepaid tuition plan, an amount is determined (based on your child's current age) that will guarantee a credit for tuition for up to 4 years. Each year of tuition that you purchase increases the cost of the contract. A separate contract can be used to purchase dormitory costs in some instances. Various terms address rebating the funds in case the child doesn't attend a state school, and most of these plans can be transferred easily to a sibling.

These plans are a great option if you want to guarantee your return on the investment and you are reasonably sure that your child will attend a public college. Be aware, however, that many states are limiting these plans now because of concerns that they will be a burden on state coffers. For example, Florida now imposes differential tuition rates for different in-state colleges and universities.

Under the other type of 529 plan, the donor of the funds (usually parents or other relatives) continues to own the account. These plans allow anyone to give up to 5 years of tax-free gift allowance at one time, meaning a couple could give $130,000 ($13,000 from each parent times five) to a child in a 529 plan at one time without incurring a gift tax liability.

Because the donors continue to own the account until the money is used, the funds can be transferred to another individual as desired. As long as withdrawn funds are used for educational purposes, the earnings on the account are not taxed. Any funds reclaimed by the owner or spent on non-educational costs are taxed (earnings only, not the original after-tax contribution) and a penalty applied. The 529 plans owned by parents or the child are counted toward the family financial contributions for financial aid considerations, but only at a 5.6% rate.

This type of 529 plan is very attractive as an estate-planning vehicle. The money used to fund the account (remember that a grandparent couple, for example, could fund $130,000 per child all at once) leaves the donor's estate, yet remains under the donor's control for potential future needs. If the owner retracts the money, the earnings on it are treated as taxable income and subject to an additional 10% penalty.

Assets put into 529 plans usually are protected by state law from lawsuits against either the owner or recipient, but check with your adviser or an attorney if this is an issue for you or you think it might become one. Also note that 529 plans established by anyone other than the child's parent (or the child) are not factored into financial aid calculations, except for actual disbursements from the account.

The 529 plans come in a variety of shapes and sizes. Many are available through no-load fund companies such as Vanguard, Fidelity, and TIAA-CREF. In most of the plans, the fund companies make asset allocation decisions, but a few of the newer plans allow some input by the fund owners. Because these plans require little in the way of investment changes over time, I recommend generally that families invest in these plans directly using only no load/commission plans.

METHODS TO AVOID

Coverdell Educational Savings Accounts These accounts allow you to invest up to $2,000 (after-tax) annually for a child's educational needs. The earnings grow and are withdrawn tax-free when used appropriately. A limit to the parents' adjustable gross income prevents most of our clients from directly funding this type of account. The law allows someone other than the parent to fund the account, however. The funds can be used for private school costs before college.

Generally, I don't recommend these accounts because of their severe funding restrictions. A 529 plan offers the same benefits (and much more flexibility) with none of the hassle in most cases.

Life insurance You may have heard of using a cash value life insurance policy to fund a college education. The idea is to use after-tax income to buy a life insurance policy on the parent or the child. The policy's cash value accumulates tax-deferred, and loans can be taken from it tax-free. I don't recommend using life insurance policies as a means of savings for education. The significant costs of these policies (especially commissions) generally make them a poor choice. Life insurance's purpose is to provide an income at death, and using it for other purposes is not a good idea.

Trusts Although several forms of trusts can be used to provide for educational costs, the expenses and hassles associated with them make this form of savings difficult to recommend. The only time I could recommend using a trust in lieu of a 529 plan or custodial account is a situation in which rigid control of fund dispersal by a third party is necessary.

LOANS, GRANTS, SCHOLARSHIPS, AND TAX CREDITS

If you have significant assets or income, your children probably will not qualify for need-based financial aid. You should still fill out the forms, however, because some schools make "allowances" to enroll students they find desirable. It would be worth discussing loan programs with your child's guidance counselor or someone at the school your child plans to attend. Forms are available at www.fafsa.ed.gov/.

Many private colleges will negotiate tuition costs. If a school wants your child to attend, this is a common method of encouraging admission. In addition, I have heard of colleges reducing tuition if asked.

Interest on student loans can be deducted at least partially by families with adjusted gross incomes of less than $150,000. As mentioned previously, two education tax credits are available for families with adjusted gross incomes at or below the $120,000-to-$180,000 range. If you are in this income range, ask about the American Opportunity and Lifetime Learning tax credits.

With proper planning and by using the methods described here, the costs associated with an education at a private school, college, and graduate school can be reduced by as much as one-third. The keys are to start early and to get expert advice from a financial planner and accountant. By so doing, you can free up funds for other uses while ensuring that family members have enough funds to pay for their education.

Useful Web sites for help with college planning:

- www.savingforcollege.com/
- www.finaid.org/
- www.collegeboard.org

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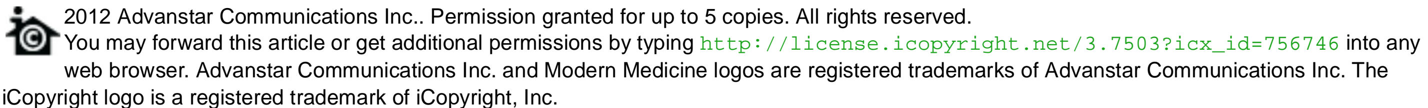
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