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TAX PLANNING FOR COLLEGE

If you are a parent with college-bound children, you are or will soon be concerned with either setting up a financial plan to fund for future college costs, or, if your children are already college age, with paying for current or imminent tuition, etc. bills. Below are several approaches that seek to take maximum advantage of tax benefits to minimize your expenses. (Please note, the following suggestions are strictly related to tax benefits. You may have non-tax-related concerns that make the suggestions inappropriate.)

PLANNING FOR COLLEGE EXPENSES

- In many cases, transferring ownership of assets to children can save taxes. You and your spouse can transfer up to $22,000 a year (for 2002) in cash or assets to each child with no gift tax consequences. For children over 13, the income from the assets is taxed entirely to them at their lower tax rates (as low as 10% in 2002). For children under 14, however, income above $1,500 (in 2002) is taxed (under the "kiddie tax" rules) at your rates.

  A variety of trusts or custodial arrangements can be used to place assets in your children's names. Note, it's not enough just to transfer the income to them, e.g., dividend checks. The income would still be taxed to you. You must transfer the asset that's generating the income into their names.

TAX-EXEMPT BONDS

- Another way to achieve economic growth while avoiding tax is simply to invest in tax-exempt bonds or bond funds. Interest rates and degree of risk vary on these, so care must be taken in selecting your particular investment. Some tax-exempts are sold at a deep discount from face and don't carry interest coupons. Many are marketed as college savings bonds. A small investment in these so-called zero coupon bonds can grow into a fairly sizable fund by the time your child reaches college age. "Stripped" munis carry similar advantages.

SERIES EE U.S. SAVINGS BONDS

- Series EE U.S. savings bonds offer two tax-savings opportunities when used to finance your child's college expenses: first, you don't have to report the interest on the bonds for federal tax purposes until the bonds are actually cashed in; and second, interest on "qualified" Series EE (and Series I) bonds may be exempt from federal tax if the bond proceeds are used for qualified college expenses.

  To qualify for the tax exemption for college use, the bonds must be purchased by you in your name (not the child's) or jointly with your spouse. The proceeds must be used for tuition, fees, etc. (not room and board). If only part of the proceeds are used for qualified expenses, then only that part of the interest is exempt. But if your adjusted gross income (AGI) is too high, the exemption is phased out. For bonds cashed in during 2002, the exemption starts to "disappear" when your AGI hits $86,400 for joint return filers ($57,600 for singles) and is gone entirely if your AGI is at $116,400 ($72,600 for singles). These figures are adjusted annually for inflation.

QUALIFIED TUITION PROGRAMS

A qualified tuition program allows you to buy tuition credits for a child or to make contributions to an account set up to meet a child's future higher education expenses. Contributions to these programs aren't deductible, and the contributions are treated as taxable gifts to the child but they are eligible for the annual $11,000 (for 2002) gift tax exclusion, and a donor who contributes more than the annual exclusion limit for the year can elect to treat the gifts as if they were spread out over a 5-year period. The earnings on the contributions accumulate tax-free until the college costs are paid from the funds. And, beginning in 2002, distributions from qualified tuition programs are tax-free to the extent the funds are used to pay qualified higher education expenses. States and their agencies or instrumentalities and private education institutions are all permitted to establish qualified tuition programs. (Note, however, that distributions from private education institution programs won't be tax-free until 2004.) Distributions of earnings that aren't used for qualified higher education expenses will be subject to income tax plus a 10% penalty tax.

COVERDELL EDUCATION SAVINGS ACCOUNTS

You can establish Coverdell education savings accounts (formerly called education IRAs) and make contributions of up to $2,000 for each child under age 18. (This age limitation does not apply to a beneficiary with special needs, defined as an individual who because of a physical, mental or emotional condition, including learning disability, requires additional time to complete his or her education.) The right to make these contributions begins to phase out once your AGI is over $190,000 on a joint return ($95,000 for singles). (If the income limitation is a problem, the child can make a contribution to his or her own account.) Although the contributions aren't deductible, funds in the account aren't taxed, and distributions are tax-free if spent on higher education expenses. If the child doesn't attend college, the money must be withdrawn when the child turns 30, and any earnings will be subject to tax and penalty, but unused funds can be transferred tax-free to a Coverdell education savings account of another member of the child's family who hasn't reached age 30. (These requirements that the child or member of the child's family not have reached 30 do not apply to an individual with special needs.)

PAYING COLLEGE EXPENSES

You may be able to take a credit for some of your child's tuition expenses, or write off some of the interest on education loans. You may also be able to take a deduction for some of those expenses you pay in 2002-2005. There are also tax-advantaged ways of getting your child's college expenses paid by others.

- TUITION TAX CREDITS

  You can take a Hope tax credit of up to $1,500 a year (for 2002) per student for the first two years of college (a 100% credit for the first $1,000 in tuition and a 50% credit for the second $1,000). You can take a Lifetime Learning credit of up to $1,000 per family for every additional year of college or graduate school (a 20% credit for up to $5,000 in tuition). Both credits are phased out for 2002 for couples with incomes between $82,000 and $102,000 (or singles with income between $41,000 and $51,000). The Hope credit amount and the phase-out ranges for both credits are adjusted annually for inflation. Only one credit can be claimed for the same student in any given year. But, beginning in 2002, a taxpayer is allowed to claim a Hope or a Lifetime Learning credit for a tax year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a Coverdell education savings account for the same student, as long as the distribution is not used for the same educational expenses for which a credit was claimed.

- DEDUCTION FOR COLLEGE COSTS (AVAILABLE 2002-2005)

  Starting this year (and only through 2005), certain taxpayers are permitted to take an above-the-line deduction for college tuition and related expenses they pay. (An above-the-line deduction is more favorable than a below-the-line deduction because it may be taken regardless of whether the taxpayer elects to take the standard deduction or to itemize deductions, and it's not subject to the overall limitation on itemized deductions or to the 2% floor on miscellaneous itemized deductions.) In 2002 and 2003, for taxpayers with AGI of up to $65,000 for singles and $130,000 for joint return filers, the maximum deduction will be $3,000. The deduction can't be taken in the same year that a Hope or Lifetime Learning credit is claimed for the same student. However, it can be claimed in the same year as an exclusion is available for distributions from a Coverdell education savings account or qualified tuition plan or for interest on education savings bonds, as long as the deduction and exclusion aren't claimed for the same expenses.

- SCHOLARSHIPS

  Scholarships (if your child qualifies for any) are exempt from income tax. For this exemption to apply, certain conditions must be satisfied. The most important are the scholarship must not be compensation for services, and it must be used for tuition, fees, books, supplies and similar items (and not for room and board). Although a scholarship is tax-free, it will reduce the amount of expenses that may be taken into account in computing the Hope and Lifetime Learning credits, above, and may, therefore, reduce or eliminate those credits. Note also, beginning in 2002, in an exception to the rule that a scholarship must not be compensation for services, a scholarship received under a health professions scholarship program may be tax-free even if the recipient is required to provide medical services as a condition for the award.

- EMPLOYER EDUCATIONAL ASSISTANCE PROGRAMS

  If your employer pays your child's college expenses, the payment is a fringe benefit to you, and is taxable to you as compensation, unless the payment is part of a scholarship program that's "outside of the pattern of employment." Then the payment will be treated as a scholarship if the other requirements for scholarships are satisfied.

- TUITION REDUCTION PLANS FOR EMPLOYEES OF EDUCATIONAL INSTITUTIONS

  Tax-exempt educational institutions sometimes provide tuition reduction plans for the children of their employees-tuition reductions for those children who attend that educational institution, or cash tuition payments for children who attend other educational institutions. If certain requirements are satisfied, these tuition reductions are exempt from income tax.

- COLLEGE EXPENSE PAYMENTS BY GRANDPARENTS AND OTHERS

If someone other than you pays your child's college expenses, the person making the payments is generally subject to the gift tax, to the extent the payments and other gifts to the child by that person exceed the regular annual (per donee) gift tax exclusion of $11,000 ($22,000 in the case of married donors who consent to split gifts) for 2002. If the other person pays your child's school tuition directly to an educational institution, however, there's an unlimited exclusion from the gift tax for the payment. The relationship between the person paying the tuition and the person on whose behalf the payments are made is irrelevant, but the payer would typically be a grandparent. The unlimited gift tax exclusion applies only to direct tuition costs. There's no exclusion (beyond the normal annual exclusion) for dormitory fees, board, books, supplies, etc. Prepaid tuition payments may qualify for the unlimited gift tax exclusion under certain circumstances.

- STUDENT LOANS

You can deduct interest on loans used to pay for your child's education at a post-secondary school, including some vocational and graduate schools. (This is an exception to the general rule that interest on student loans is personal interest and, therefore, not deductible.) The deduction is an above-the-line deduction, meaning it's available even to taxpayers who don't itemize. The maximum deduction is $2,500. However, the deduction phases out for taxpayers who are married filing jointly with AGI between $100,000 and $130,000 (between $50,000 and $65,000 for single filers).

Some student loans contain a provision that all or part of the loan will be canceled if the student works for a certain period of time in certain professions for any of a broad class of employers-e.g., as a doctor for a public hospital in a rural area. The student won't have to report any income if the loan is canceled and he performs the required services. This is an exception to the general rule that if a loan or other debt you owe is canceled, you must report the cancellation as income.

- BANK LOANS

The interest on loans used to pay educational expenses is personal interest which is generally not deductible (unless you qualify for the deduction for education loan interest, described above). However, if the loan is "home equity indebtedness," and interest on the loan is "qualified residence interest," the interest is deductible for regular income tax purposes, although not for alternative minimum tax purposes. If interest is deductible as qualified residence interest, it can't be deducted as education loan interest.

- BORROWING AGAINST RETIREMENT PLAN ACCOUNTS

Many company retirement plans permit participants to borrow cash. This option may be an attractive alternative to a bank loan, especially if your other debt burden is high. However, the loan must carry an interest rate equal to the prevailing commercial rate for similar loans, and, unless you qualify for the deduction for education loan interest (described above), there's no deduction for the personal interest paid. Moreover, unless strict requirements are satisfied, a loan against a retirement account is treated as a premature distribution that's subject to regular income tax and an additional penalty tax.

- WITHDRAWALS FROM RETIREMENT PLAN ACCOUNTS

IRAs and qualified retirement plans represent the largest cash resource of many taxpayers.

You can pull money out of your IRA (including a Roth IRA) at any time to pay college costs without incurring the 10% early withdrawal penalty that usually applies to withdrawals from an IRA before age 591/2 . However, the distributions are subject to tax under the usual rules for IRA distributions.

Some qualified plans either don't permit withdrawals or restrict them. For example, a 401(k) cash-or-deferred plan may allow distributions if the participant has an immediate and heavy financial need and lacks other resources to meet that need. IRS regs name a college education as such a need. To the extent they represent previously untaxed dollars and earnings, amounts withdrawn from a retirement plan are fully subject to tax and are also hit by a 10% penalty tax if they are made before the participant reaches age 591/2 . Note, however, you cannot roll over a 401(k) plan "hardship" distribution into an IRA to set up a later penalty-free withdrawal to pay college costs.

A younger plan participant may avoid triggering the penalty tax by annuitization payouts from an IRA or a SEP. This method doesn't work for 401(k) type plans. The strategy works because the penalty tax doesn't apply if annual or more frequent withdrawals are made in substantially equal payments over the life or life expectancy of the taxpayer (or the joint lives or joint life expectancies of the taxpayer and designated beneficiary).

Not all of the above breaks may be used in the same year, and use of some of them reduce the amounts that qualify for other breaks. So it takes planning to determine which should be used in any given situation.