WHAT IS THE BEST WAY TO SAVE FOR OUR CHILDREN'S EDUCATION?

Fortunately, over the past few years Congress has recognized that the cost of education has escalated and taxpayers need tax relief in order to adequately prepare for the financial realities of educating their children and grandchildren. But, as a result, the variety of options may confuse taxpayers who want to maximize their tax benefits while preparing for future education needs. Moreover, investment options and strategies can create added challenges and financial aid implications can be problematic. It is important that each parent (or grandparent) planning for their children's education understands the various options in order to select the savings plan(s) most appropriate to their needs.

The following information gives the reader a quick overview of the various savings options and well as outlining other tax advantages and financial aid considerations.

If you have any questions about this information or other tax, accounting or financial issues, please allow us to assist you.

Larson Accounting and Tax Service

EDUCATIONAL SAVINGS PROGRAMS

EDUCATION SAVINGS BONDS

An individual who redeems qualified U.S. Savings bonds may exclude the interest from the redemption proceeds from income up to the amount of qualified higher education expenses. This is a very safe investment with low to moderate return.

Qualified U.S. Savings bonds are defined as Series EE savings bonds issued at a discount after 1989 and Series I Bonds. The taxpayer must be at least 24 years old before the bond's issue date and the bonds must be registered either in the name of the taxpayer or in the names of the taxpayer and spouse (not in the name of a child).

<u>Qualified higher education expenses</u> include tuition and fees. Beginning in 1998, contributions to qualified tuition programs (QTP) and Coverdell Education Savings Accounts also qualify. Note that room, board, books, supplies, etc, are not included in higher education expenses. The qualified expenses must be incurred for the taxpayer, taxpayer's spouse or the taxpayer's dependent at an eligible educational institution such as a public or non-profit university, college, or vocational school eligible for federal fund.

HOPE Scholarship Credit, Lifetime Learning Credit, QTP payments or reimbursements, Coverdell Education Savings Account payments, scholarship and fellowships, veteran's benefits, and other tax-exempt education benefits must reduce the expense.

Bond proceeds (principal plus interest) exceeding qualified higher education expense reduce the interest exclusion. Example: If 50% of total proceeds are used to pay for tuition after the reduction for the learning credit, education IRAs, scholarship, VA benefits, and QTP payments or reimbursement, 50% of the interest portion is excludable.

The exclusion phases out based on modified AGI in the year of redemption changes annually so call the office for the current amounts of the phase out.

The deduction is not available for Married Filing Separate returns.

The election to exclude interest must be made in the year of bond redemption on Form 8815. The form is used to record redemption of qualified U.S. Savings bonds and to compute the interest portion when the bonds are redeemed. It is for the taxpayer's use and is not filed with the parents' or child's tax return.

Planning Tip: It appears that a grandparent can purchase the bonds and, upon making a gift, register them in the parents' name.

529 PLANS - QUALIFIED TUITION PROGRAMS (QTP)

Qualified Tuition Programs (QTP), formerly known as Qualified State Tuition Programs (QSTP) were recognized in 1996 by the federal taxing authorities. Until that time, state tax benefits were available but the IRS did not recognize any special tax treatment on contributions or earnings. Now, in addition to programs in all 50 states, known as College Savings Accounts (CSA's), educational institutions are allowed to establish prepaid tuition plans (PTP's) under Section 529. Most states allow non-residents to contribute to their plans and many states allow withdrawals to be spent in out-of-state educational institutions. There is a tremendous amount of variety in the programs offered by each state and each institution. Taxpayers are advised to review the various plans to maximize their benefits.

Key features of 529 plans are:

- Earnings are tax-free. However, the taxpayer needs to be aware that the exempt nature of the earnings are due to sunset at the end of 2010. Unless Congress revises the current law, earnings distributed after that date will be taxed at the student's tax rate. Contributions are not deductible for federal purposes but are deductible in many states, including Missouri.

- Maximum contributions vary by state but generally are very generous. For example, the MO$T plan in Missouri allows for a state tax deduction of $8,000 per taxpayer ($16,000 for a married couple) and the overall lifetime limit on contributions is $100,000 per student-beneficiary.

- Anyone can contribute to a plan for a given beneficiary. The contributor retains control of the assets until distributions are made to the beneficiaries. The contributor also retains control of when and how much is to be distributed.

- Non-qualified withdrawals are taxed at both the federal and state level. Furthermore, a penalty of 10% is imposed unless the withdrawals are due to the beneficiary's death or disability or are made due to a tax-free scholarship or other educational assistance allowance or payment.

- Financial aid awards can be adversely affected. The balance in the plan is considered an asset of the account owner (the contributor) for financial aid purposes. While this may not be a problem if the account owner is someone other than a parent, withdrawals are treated as income to the beneficiary and subject to the 50% inclusion. In prepaid tuition type of 529 plans, the tuition payments are treated as a resource of the student, thus potentially reducing need-based aid.

- Distributions are not included as income if they are rolled over within 60 days to a 529 Plan of a new beneficiary who is a member of the old beneficiary's family. This rule includes first cousins.

- The contribution is treated as a completed gift of a present interest from the contributor to the beneficiary. Furthermore, a special election is available by filing gift tax returns and electing to take the contribution ratably over 5 years – thus allowing a contribution up to $50,000 without affecting the unified credit for estate purposes.

For years after 2001, the Hope or Lifetime Learning Credits may be claimed. However, the tax-free treatment allowed will not apply to any amounts used to pay for these credits. A student or the student's parents may claim a Hope credit or Lifetime Learning credit for qualified tuition and related expenses covered by a 529 plan provided the other eligibility requirements are met.

Planning Tip: 529 Plans are an excellent planning vehicle for grandparents who want flexibility to transfer benefits from one grandchild to another.

COVERDELL EDUCATION SAVINGS ACCOUNTS (EDUCATION IRA'S)

A Coverdell Education Savings Account (ESA) is a custodial account or trust maintained to pay qualifying higher education expenses of the designated beneficiary. Effective for years after 2001, ESA's are being expanded to include not only post secondary education expense, but also include expenses at public, private, or religious elementary and secondary schools and contributions may be made to a 529 Plan and to an ESA in the same year without penalty.

<u>Qualifying expenses</u> include all costs of attendance at a qualified institution including tuition and fees, tutoring, special needs services, books, supplies, room and board, uniforms, transportation, purchase of computers and supplementary items and services including extended day programs.

Key features of ESA plans are:

- Contributions are limited to a maximum of $2,000 per child per year and limited for the benefit of persons under age 18 (unless the student has special needs as defined by the regulations).
- Contributions are not deductible by the contributor nor are they taxable to the beneficiary.
- A child may contribute to his or her own ESA. Contributions may be made up until April 15th of the following year and still be treated as a prior year's contribution.
- Excess contributions are subject to a 6% annual tax imposed on the beneficiary.
- Distributions from an ESA are tax free up to qualified higher education expenses regardless of whether the beneficiary is enrolled full time or part time.
- When distributions exceed the qualified education expenses, a portion of the earnings included in the withdrawal is taxed to the beneficiary. In addition, excess distributions are subject to a 10% penalty unless the distribution is made because of the beneficiary's death or disability or as a result of the beneficiary receiving a nontaxable scholarship or similar assistance.
- Beginning in 2002, (yes, it has been that long already) the Hope and Lifetime Learning credits may be claimed in the same year as exclusions from income are taken for distribution from an ESA. The ESA distribution must not be used to pay for the same educational expenses for which a credit claimed.
- Amounts remaining in an ESA must be distributed within 30 days after the beneficiary reaches age 30; the earnings are subject to income tax and 10% penalty unless one of the above exceptions are met. The tax and penalty can be avoided by rolling over the ESA to another family member.
- Contributions to an ESA are treated as completed gifts of a present interest from the contributor to the beneficiary for gift tax purposes. For estate tax purposes, the value of the ESA is included in the estate of the beneficiary and not the contributor.

The exclusion phases out based on modified AGI change annually, please call the office for current amounts.

Planning Tip: Parents or others who are restricted from contributing to an ESA for a student because of the AGI limitations should consider making a cash gift to the student who then contributes the amount to an ESA.
Planning Tip: A student beneficiary may waive the tax-free treatment of a distribution from an ESA and elect to include the otherwise taxable portion of the distribution (i.e. the earnings) in income and pay the tax due. The 10% penalty does not apply to amounts included in income because of this election.

OTHER EDUCATIONAL TAX SAVINGS OPPORTUNITIES

HIGHER EDUCATION EXPENSE DEDUCTION

This tax legislation has been extended through 2009. Expenses must qualify as higher education expenses as defined in the same manner as for the Hope credit but is not available for any year in which the Hope or Lifetime Learning credits are claimed for any expenses of the student, regardless of income levels.

The deduction is limited based on the taxpayer's AGI and the year the deduction is claimed:
It can be as much as $4000, but is not available if Modified AGI is more than $180,000 for joint filers or $90,000 for single taxpayers.

The deduction is not available for expenses paid with tax-free withdrawals from Cloverdell Education Savings Accounts, tax-free withdrawals from 529 Plans, or excluded interest from Education Savings Bonds. Unlike Education Savings Accounts, the excluded amount from 529 Plans include only the amount attributed to earnings portion. The original contributions to the 529 Plan are not considered.

HOPE SCHOLARSHIP AND LIFETIME LEARNING CREDITS

The <u>Hope Scholarship Credit</u> has been enhanced and renamed the "American Opportunity Tax Credit". The credit is now partially refundable for 100% of the first $2,000 and 25% of the next $2,000 for post-secondary tuition, fees and qualified expenses. Under the new law, the maximum annual credit is $2,500 per eligible student. Credit is based on per student per year – a family may have more than one eligible student in one tax year. The Hope credit can now be claimed for the first four years of post-secondary education. The term "qualified tuition and related expenses" has been expanded to include expenditures for course materials, including books, supplies and equipment.

<u>Eligible students</u> must be enrolled in a program that leads to a degree, certificate or other recognized educational credential and must take at least one-half the normal full-time work load for the course of study for at least one academic period beginning during the tax year. The student must be free of any felony conviction for possessing or distributing a controlled substance.

The <u>Lifetime Learning Credit</u> is a nonrefundable tax credit of 20% of up to 10,000 of qualified tuition and fees paid during the tax year for a maximum credit is $2,000. The credit is not based on course load and is available to both degree and non-degree seeking students enrolled in undergraduate, graduate, professional degree programs.

Both the Hope and Lifetime Learning credits phase-out based on modified adjusted gross income at the following levels:

	2008	2009
Filing Status	Phase-Out	Phase-Out
Married filing joint	$63,000 - $116,000	$160,000 - $180,000
All other filing statuses	$48,000 - $ 58,000	$ 80,000 - $ 90,000

Beginning in 2002, education credits and exclusions may both be claimed during the same year. The coordination rules require qualified education expenses to be reduced in the following order:

- Amounts excluded from income such as scholarships and employer-provided assistance, then
- Amounts used to claim education credits such as the Hope and Lifetime Learning credits.

If a student received a distribution from both a Coverdell ESA and a Qualified Tuition Program that are more than the reduced expenses, the expenses must be allocated between the distributions.

STUDENT LOAN INTEREST DEDUCTION

An individual may deduct interest paid after December 31, 1997 on any qualified education loan. The deduction is "above the line" meaning that even taxpayers who do not itemize may benefit from the deduction. The maximum amount a taxpayer is permitted to deduct, regardless of the number of students in the family, is limited to $2,500. Furthermore, the interest deduction is phased out for individuals with the following modified adjusted gross income:

Filing Status	2008 Phase Out	2002 Phase Out
Married filing joint	$115,000 - $145,000	$115,000 - $145,000
Surviving spouse	$115,000 - $145,000	$115,000 - $145,000
Single	$55,000 - $70,000	$ 55,000 - $ 70,000
Head of Household	$55,000 - $70,000	$ 55,000 - $ 70,000

The deduction is not available for Married filing separate returns or individuals that are claimed as a dependent by another taxpayer.

A <u>qualified education loan</u> includes any indebtedness used solely to pay for qualified higher education expenses such as tuition, fees, room, board, books, supplies and transportation for a student enrolled at least half time in a program leading to a degree, certificate or other recognized educational credential. The taxpayer, spouse, or dependent at the time the loan was taken out must have incurred the loan.

<u>Qualified higher education expenses</u> means the cost of attendance as defined in the Higher Education Act of 1965. Such expenses are reduced by tax exempt scholarships, employer education assistance programs, excluded interest from Educational Savings Bonds and distributions from Cloverdell Education Savings Accounts. Generally, no above-the-line deduction is allowed for interest where a deduction is allowable under any other provision of the Code. Student loan interest that doesn't qualify is considered non-deductible personal interest.

<u>Eligible educational institutions</u> include colleges, universities, vocational schools and other post secondary educational institutions.

<u>Qualified lenders</u> include financial institutions, governmental units, educational institutions and others providing qualified education loans. The key to the interest being deductible is that the debt must be incurred "solely" for the educational purpose. A loan does not have to be issued or guaranteed under federal post-secondary education loan program to be a qualified education loan. Interest on equity loans taken out before 1998 that qualify for deduction under the home equity loan rules cannot be deducted above-the-line and must be used as an itemized deduction. For loans made after 1997 that are secured by real property other than acquisition indebtedness, the interest is characterized as student loan interest if the borrower certified the loan as a student loan to the lender and the loan proceeds were used solely for qualifying educational purposes. However, loans from persons related to the taxpayer cannot be qualified education loans.

Through 2001, the deduction is allowed only with respect to interest paid during the first 60 months. However, the 2001 Tax Act removed the 60-month time limit for interest deductions on student loans. Starting in 2002, there will no longer be any time limit on the deductibility of interest on such loans.

Only the individual who is legally required to make interest payments under the loan terms may claim the deduction. Proposed regulations clarify that the deduction is not allowed to an individual who is properly claimed as a dependent on another's return for that year. Example: Sandi Beach paid qualifying student loan interest during the tax year but is claimed by her father Rock. Neither Sandi nor Rock can claim the deduction.

Planning Tip: Many parents may exceed AGI limits and most recent college graduates probably will not. Generally, taxpayers should consider taking out the loans in the student's name to ensure a deduction.

REGULAR AND ROTH IRA DISTRIBUTIONS FOR EDUCATION

The 10% penalty tax on early IRA distributions does not apply to distributions for qualified higher education expenses. This penalty exclusion applies to expenses incurred by the taxpayer, taxpayer's spouse, child or stepchild without regard to income limitations.

Qualified higher education expenses are defined the same as for Qualified Tuition Programs and Cloverdell Education Savings Accounts. The amount of qualified higher education expenses must be reduced by Hope and Lifetime Learning credits, tax exempt scholarships and educational IRA distributions.

FINANCIAL AID

FINANCIAL AID CONSIDERATIONS

Approximately one-half of the 16.7 million students enrolled in U.S. postsecondary study receive some form of financial aid. It is important to understand the financial aid system when analyzing the optimum educational savings programs.

Colleges compute student financial aid awards by calculating the college's cost of attendance (COA) and then subtracting the expected family contribution (EFC). Any remaining amount may be funded by financial aid. Other considerations are how early the financial aid application is turned in and the particular school's available financial aid resources. Each college is responsible for calculating the cost of attendance and such amounts can vary a great deal.

Example:

Expected cost of attendance for one year:	
Tuition & fees	$12,000
Room & board	4,000
Books & supplies	2,000
Transportation	500
Total	$ 18,500
Expected family contribution	(12,500)
Financial Need	$ 6,000
Less Student Resourced:	
Rotary scholarship	(500)
529 plan distribution	(1,500)
Adjusted financial need	$ 4,000

Most colleges use the Federal Methodology for calculating the Expected Family Contribution (EFC). The formula for calculation under this method incorporates income based on the year before financial aid is needed and value assets on the date the application is signed. The EFC is the sum of:

- 50% of student's income less $2,200-$8,000 (depending on marital and school status) and deductions for taxes plus
- 35% of student's assets, plus
- 22-47% (based on income level) of parent's income , less deductions for taxes, employment allowance and food and clothing allowances, plus
- 5.6% of parent's assets less deductions for investment debt, retirement accounts, business debts, business discounting, retirement allowance and personal residence equity.

Some private institutions use a variation of the Federal Method, referred to as the Institutional Method. This method provides a different figure for the EFC. If a student is considering a private school, it is wise to check with the Financial Aid Office of that institution to determine the calculation methodology.

Financial aid awards come in two basic types: gift aid and self-help. Gift aid consists of scholarships or grants. These gifts are available for a variety of reasons such as financial need or academic, artistic, or athletic merit. Self-help aid consists of various education loan programs and work-study. Some of the loan programs available are described below. Financial aid is funded from a variety of sources including federal and state government programs, college programs, employers, veteran programs and private scholarships.

In many circumstances, financial aid awards are significantly reduced due to the parent's income and assets. As a result, many taxpayers would like their students to be able to file independently and not report parental information. In order to be considered independent for financial aid purposes, the student must meet one of the following tests:

- Be 24 years old by December 31st of the year the FAFSA form is signed
- Must be a veteran of the US armed forces and not have been dishonorably discharged
- Must be a graduate or professional student
- Must be married or have a dependent other than a spouse
- Both parents must be deceased or must be a ward of the court
- Must be considered independent by the financial aid officer at the college based on special circumstances

Planning Tip: Where financial aid is concerned, often tax savings are dwarfed when compared to potential financial aid awards. This is especially true where income-producing assets are shifted from taxpayer to child in order to shift the tax burden of the income.

FINANCIAL AID STRATEGIES

Several strategies should be considered in order to maximize available financial aid.

- Reposition assets – more 401k's, IRA's, annuities and cash value on life insurance. Consider no load and no surrender charge products for transfer after college.
- Reduce investment income
- Consider not shifting assets from parents to children
- Reduce debt and pay expenses
- Plan for two or more students in college at the same time
- For financial aid purposes, it is advantageous for the parent with fewer assets/lower income to retain custody in the case of a divorce
- Prepay the home mortgage in order to reduce assets
- Defer capital gains after college
- C Corp owners might be able to reduce salary
- Grandparent strategies include:
  - The grandparent keeps control of an investment and sends monthly earnings to the student

- The grandparent sets up an educational trust by making an irrevocable gift from his/her estate
- The grandparent pays college tuition directly. The payment is treated as a qualified transfer an does not reduce the $10,000 annual gift
- The grandparent contributes to a qualified state tuition program on behalf of a grandchild

EDUCATIONAL LOAN OPTIONS

Perkins loans are low interest (5%) loans ranging up to $4,000. They are awarded on a need based criteria through the financial aid process.

Federal Subsidized Staford loans are awarded to students based on need. The federal government makes the interest payments until six months after the student leaves college. At that time, the student begins repayment on a variable rate loan. The interest rate is capped at 8.25%.

Federal Unsubsidized Stafford loans are available to most students regardless of need. Interest begins accruing immediately and repayment begins 6 months after the student leaves school. Both types of Stafford loans are in the student's name.

Federal Parent's Loans for Undergraduate Students (PLUS loans) are available to the parents of college students and are not need based. The maximum amount that may be borrowed is the cost of attendance less any other financial aid received by the student. These loans are not federally subsidized and repayment begins immediately unless the signatory parent is enrolled at least half-time in college. The interest rate is variable and capped at 9% with no collateral required. PLUS loans may be amortized up to 30 years. Only one parent is required to sign for the loan. If, at a later date, the signing parent dies or becomes disabled, the remaining balance on the loan may be forgiven.

Signature Student Loan program is available through Sallie Mae. These loans are in the student's name, but a parent usually must co-sign. Repayment may be deferred until after the student leaves school; however, interest begins accruing immediately.

Students and parents would also be wise to check with the college and the state where the college is located for any locally administered loan programs.

OTHER INFORMATION AND RESOURCES

www.savings for college.com – all the information you'll ever need to know about 529 plans

www.collegesavings.com - general information about saving or college

www.collegeboard.com - comprehensive sites for financial aid calculators, college search's and other financial aid info

www.ed.gov - latest information on education issues

www.fafsa.ed.gov - free application for federal student aid

www.fastweb.com - free, searchable scholarship database that locates sources of financial aid suitable to the student

www.collegexpress.com - general information, cost and financial aid calculators, etc.

www.collegeview.com - search engine of over 3,500 colleges, virtual campus tours

www.usnews.com - general site with various college rankings and other information

www.missourimost.org - State of Missouri's web site for information about the state's 529 plan (MO$T).