

Saving for College and Beyond:

Tax-Advantaged Ways for Parents and their Young Adults to Build a Nest Egg©

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Probably the single most popular college saving technique these days is the “529 savings plan,” named for the Internal Revenue Code section that authorizes it. A 529 savings plan is run by a state, which selects a variety of investment providers, like Vanguard or Fidelity, and a variety of funds, like growth, balanced, age-adjusted, and savings account. The person saving for college (let’s say, a parent or grandparent) contributes to a fund established for a beneficiary. The owner can choose any one or several of the offered investments, just like any other investment account. The owner can invest directly with the state plan, or through a broker.

The main advantage of a 529 savings plan is the income tax break: to the extent that the funds are used for qualified higher education expenses, i.e., college tuition, room and board, the earnings of the account are not subject to federal income tax. In addition, many states give their residents special state income tax breaks. For example, in Ohio, not only are the earnings of the Ohio 529 savings plan not subject to Ohio income tax, but a resident can deduct \$2,000 of contributions per year. Finally, special gift tax rules apply to 529 savings plans, allowing them to be “front-end loaded.”

The beneficiary can use the money to go to any college anywhere in the United States, not just an in-state school. If the beneficiary doesn’t go to college, a new beneficiary (such as a younger sibling) can be named or the account can simply be cashed out. In the latter case, a 10% penalty will be incurred, but if the funds have been invested for a long enough period of time, the value of tax deferral will more than make up for the penalty.

You can learn more about the Ohio 529 savings plan, called College Advantage, at www.collegeadvantage.com.

A good source of general information is www.savingforcollege.com. That site includes information on all states’ plans. Generally speaking, you will get the best deal investing directly in your own state’s 529 savings plan, but it pays to research the plan that suits your own family’s needs.

The IRS provides the following resources:

Tax Topic 313 – Qualified Tuition Programs <http://www.irs.gov/taxtopics/tc313.html>

Publication 970 – Tax Benefits for Education <http://www.irs.gov/publications/p970/index.html>

What if I want a little more planning flexibility? You’re right, 529 savings plans are great, and for many people will be the mainstay of their college savings program, but there are other kid-friendly estate planning tools that don’t invoke the kiddie-tax.

Coverdell Education Savings Account (“ESA”). A person with annual modified adjusted gross income (MAGI less than \$110,000 (\$220,000 if filing a joint return), can establish an ESA to

finance the qualified education expenses of a designated beneficiary. The total contributions in any year cannot be more than \$2,000 per beneficiary. Contributions can only be made while the beneficiary is under age 18.

Like the 529 savings plan, the significant advantage is that distributions, including earned income, are tax-free if for a qualified education expense. In this case, however, use of the funds is not limited to higher education; primary and secondary education expense is a qualified use.

Another flexibility feature of the ESA is that the owner sets it up, much like an IRA. Almost any financial services provider will have the forms for an ESA. For example, Vanguard's website provides ESA information on-line.

Although the income, contribution, and age limits of the ESA tend to make it more restricted in size than the 529 savings plan, a program of early and regular contributions by parents or grandparents can result in a significant fund by the time the student reaches high school. This fund would then be available not only for college, but for high school expenses, including a computer or tutoring.

ESAs are discussed in more detail in IRS Publication 970 – Tax Benefits for Education.
<http://www.irs.gov/publications/p970/index.html>

But you're still giving me education-related ideas. You're right again. I promised flexible estate planning ideas. Here's one that isn't education-related.

Roth IRA. Suppose Junior is 16 and makes \$350 a week as a lifeguard at a city pool for 12 weeks. That's \$4,200 he could be saving for his future needs, whatever those are, even retirement. After all, he might get a full scholarship to college, or not go to college at all.

Junior can set up a Roth IRA in his name and contribute \$4,000 of his earnings to it. He cannot deduct his contribution, but he does not need the deduction. Just like a regular IRA, the earnings in his account will not be subject to income tax while they remain in the account. We all know about the power of compounding. If Junior indeed keeps the account invested to retirement age, he will have an account worth a significant amount, all of which can be withdrawn tax-free and without penalty after age 59-1/2.

Junior might be a lifeguard but he's not dumb. He knows that age 59-1/2 is more than 40 years from now. Before he puts his \$4,000 in a Roth IRA, he wants to know, "What if I need the money sooner than that?" He can also withdraw the money tax-free and penalty-free (a "qualified distribution") anytime more than five years after he opens the account if he uses the money for purchase of his first home or if he is disabled. (This exception applies to additional contributions to the account that have themselves been in the account less than five years.)

But what if it turns out Junior needs the money for college or graduate school after all? True, the distribution will not be a "qualified distribution," but let's break down the components to see if anything really bad happens. First, there will not be a penalty because the penalty does not apply to the extent that you spend the Roth IRA funds on qualified higher education expenses. Second,

your contributions are never taxed when they are returned to you. Third, the “income” portion of the distribution (i.e., the income earned in the account) will be taxed to Junior, but he will likely be in a low tax bracket and the kiddie tax will not apply (if he is still under age 24) because Roth IRA distributions are considered earned income. So Junior will be no worse off, and maybe better off, than if he had simply invested the money in a regular account and then used it for college or graduate school.

The penalty for early distribution is also waived for unreimbursed medical expenses and for medical insurance premiums while unemployed.

In sum, the Roth IRA offers a tax-free saving vehicle for young adults. The funds will be available penalty-free in many appropriate-use situations. Although the accumulated income will be taxed in some of those situations, it will not be subject to the kiddie tax and those will likely be low tax bracket situations.

The IRS provides the following comprehensive publication, which includes a discussion of Roth IRAs:

Publication 590 (2006), Individual Retirement Arrangements (IRAs)
<http://www.irs.gov/publications/p590/index.html>