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Children and Family Finances -- Saving for College

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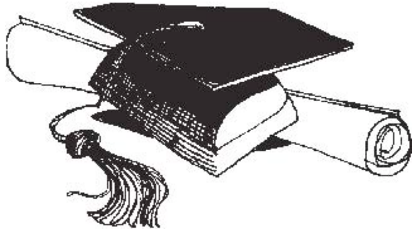

It is never too early to start saving for your child's college or professional education. Colleges and professional schools are expensive and being able to pay may allow your child to consider more schools and institutions. For information on tax savings when you pay college expenses, see the fact sheet entitled *Children and Family Finances – Paying for College* in this series.

Some of the plans mentioned below also allow you to pay for primary and secondary school expenses. The earlier you start, the more compound interest can work for you to increase your savings. For more detailed information see IRS publication 970, *Tax Benefits for Education.*

Taxable Savings

There are many ways to save for college. You can use regular investments and savings accounts, but the earnings will be taxed every year at your tax rate.

Uniform Gifts to Minor (UGMA)

You can use Uniform Gift to Minor Accounts (UGMA). These can be used with any type of investment or savings account. They are held in the child's name with you as custodian until the child reaches legal age, which is 18 in most states. In 2009, the first $1,800 of earnings from these accounts will be taxed at the child's rate. Any amount over that is taxed at the parents' rate as long as the child is under 18. The advantage of this type of investing is that the funds can be used for the benefit of the child at any time and not just for school expenses. The disadvantage of these accounts is that the money goes to the child at age 18 whether or not he or she goes to college.

When applying for financial aid, a larger percentage of money that is in the child's name will be required to be used for paying college costs than money that is saved in the parents' name. Therefore, you may want to limit the amount invested in the child's name to an amount that will qualify to be taxed at the child's rate or money that is saved using pre-tax dollars.

Tax Advantage Savings

There are several ways to save tax free for college: U.S. savings bonds, Qualified State Tuition Programs (QSTPs) also know as 529 plans, and Coverdell Education Savings Accounts (ESAs) (formerly known as Educational

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Individual Retirement Accounts). You cannot contribute to a Coverdell ESA and a QSTP in the same year. In addition, Coverdell Education Savings Accounts can be used to pay for certain elementary and secondary school expenses.

U.S. Savings Bonds

A qualified U.S. Savings Bond is a Series EE bond issued after 1989 or a Series I Bond. The bond must be issued in one or both parents' names and the owner must be at least 24 years old when the bond is issued. The issue date is printed directly on the front of the savings bond. Since the bonds are in a parent's name, they can be used for a child or the parents. Qualified U.S. Savings Bonds can be used for other purposes; you will just have to pay tax on the interest. They are also easy to purchase through a payroll savings plan with larger employers, at any bank, or directly from the Federal Reserve.

Parents may be able to cash qualified U.S. Savings Bonds without having to include the interest in their income if they meet the following conditions in the year they cash the bonds.

- Their modified adjusted gross income meets certain limits.
- Their filing status is not "married filing separate".
- They pay qualified higher-education expenses for themselves, their spouse, or a dependent who they claim as an exemption on their federal income tax return.

What are the Qualified Higher Education Expenses?

- Tuition and fees required to enroll in or attend any college, university, vocational school, or other postsecondary educational institution that would be eligible to participate in a student aid program administered by the Department of Education (Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program).
- Contributions to a qualified state tuition program
- Contributions to a Coverdell ESA

Expenses must be reduced by the amount of any of the following benefits received by the student.

- Tax-free scholarships
- Tax-free withdrawals from a Coverdell ESA
- Any nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses or for attending an eligible educational institution, such as:
    - Veterans' educational assistance benefits
    - Benefits under a qualified state tuition program
    - Tax-free, employer-provided educational assistance
    - Any expenses used in figuring the Hope Scholarship Credit and Lifetime Learning Credit

Qualified State Tuition Plans (529 plans)

Under current law, a qualified state tuition program (QSTP) means a program established and maintained by a state under which a person may: (1) prepay tuition benefits on behalf of a beneficiary so that the beneficiary is entitled to a waiver or a payment of qualified higher-education expenses, or (2) contribute to an account that is established for paying qualified higher-education expenses of the beneficiary. The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QSTP. The beneficiary pays tax on the earnings at the time of distribution. If amounts saved through a QSTP are used to pay for college, the student or the student's parents still may be eligible to claim either the Hope Scholarship Credit or the Lifetime Learning Credit. The web site, http://www.virginia529.com , gives comparisons of these plans in Virginia.

Depending on the plan, the QSTP may cover some or all of the following expenses: tuition, fees, room and board, textbooks, and computers. It may guarantee to cover all tuition (referred to as a lock-in price) or only as much as is saved. To receive guaranteed, fully-paid tuition (also known as a lock), the child usually needs to attend a school in the state that is offering the plan. A caution when looking for an appropriate plan is to find one that is mobile and will cover any school the child attends. Mobile plans may only guarantee full tuition for the state where they are located and the amount saved if the child attends school in another state. An advantage of these plans is that they cannot be touched by your creditors if you have financial difficulties in the future.

Coverdell ESA (formerly known as an Education IRA)

A Coverdell Educational Savings Account is a trust or custodial account. It is created for the exclusive purpose of paying the qualified higher-education expenses of the account's designated beneficiary. For tax purposes, the Coverdell ESA must be designated as such when it is created. Coverdell ESAs are available through any bank, or other entity approved to serve as a nonbank trustee or custodian of an individual retirement account (IRAs). Coverdell ESAs are permitted to accept contributions made in cash only. Parents, grandparents, other family members, friends, and the future student may contribute a total of $2,000 per year into a Coverdell ESA. The child must be under age 18 unless he or she has special needs as defined by the Internal Revenue Service. However, there are income limitations (similar to the limits for Roth IRAs) for the contributors. See IRS Publication 970 for the current limits. Amounts deposited in the account grow tax-free until they are distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher-education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal. If the child does not need the money for postsecondary education, the account balance can be rolled over to the Coverdell ESA of certain family members who can use it for their higher education. Like a Roth IRA, these contributions are not tax-deductible. You may contribute to a Coverdell IRA even if contributions are being made to a Qualified State Tuition Plan (529) for the same child.

Amounts withdrawn from a Coverdell ESA that exceed the child's qualified higher education expenses in a taxable year are generally subject to income tax and to an additional tax of 10%. You may be able to use the Hope Scholarship Credit, Lifetime Learning Credit, or a withdrawal from a Qualified State Tuition Plan in addition to the tax-free withdrawal from a Coverdell ESA, but not for the same expenses. Whether the designated beneficiary is enrolled full-time, half-time, or less than half-time, he or she may take a tax-free withdrawal to pay qualified higher-education expenses.

What are the Qualified Higher Education Expenses?

Qualified higher-education expenses mean expenses are for

- Tuition, fees, books, supplies, and equipment necessary for the designated beneficiary to enroll in or attend an eligible educational institution
- Room and board (generally the school's posted room and board charge, or $2,500 per year for students living off-campus and not at home) if the designated beneficiary is at least a half-time student at an eligible educational institution
- Contributions to a qualified state tuition program

Eligible Educational Institution

Eligible educational institutions include any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Hope Scholarship Credit, the Lifetime Learning Credit, and early withdrawals from IRAs for qualified higher-education expenses.)

In addition, you may withdraw funds to pay for tuition, fees, books, academic tutoring, room and board, uniforms, transportation, and a computer for any private, public, or religious kindergarten-through-twelfth-grade school.

What happens if there is money left over in the account?

There are two options. The amount remaining in the account may be withdrawn for the designated beneficiary. The designated beneficiary will be subject to both income tax and the additional 10% tax on the portion of the amount withdrawn that represents earnings if the designated beneficiary does not have any qualified higher-education expenses in the same taxable year that he or she makes the withdrawal.

Alternatively, if the amount in the designated beneficiary's Coverdell ESA is rolled over to another Coverdell ESA for the benefit of a member of the designated beneficiary's family, the amount rolled over will not be taxed. An amount is rolled over if it is paid to another Coverdell ESA on a date within 60 days after the date of the distribution. Members of the designated beneficiary's family include the designated beneficiary's children and their descendants, stepchildren and their descendants, siblings and their children, parents and grandparents, stepparents, and spouses of all the previously mentioned beneficiaries. For example, an older brother who has $2,000 left in his Coverdell ESA after he graduates from college can roll over the full $2,000 balance to a Coverdell ESA for his younger sister who is still in high school without paying any tax on the transfer.

IRAs, Sep-IRAs, Roth IRAs, and Simple IRAs

You can save for college expenses for yourself, your spouse, or your or your spouse's child, foster child, adopted child, or descendant of any of them in any type of IRA for which you qualify. You can withdraw money from an IRA and avoid the penalty for early withdrawal (10% - 25% of the withdrawal depending on the type of IRA) for tuition, fees, books, supplies, and equipment required for enrollment and for special needs services for special needs students. The student must be enrolled at least half-time. However, you will still owe income tax on the withdrawal.

Eligible educational institutions include any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. Certain educational institutions outside the United States that participate in the U.S. Department of Education's Federal Student Aid (FSA) programs are also eligible education institutions.

Remember if you withdraw these funds to pay for educational expenses, they will not be available for your retirement.

This is one of a set of fact sheets entitled *Children and Family Finances*. You may also want to see the series *Planning for Baby*.

This fact sheet was revised from Planning for Baby – Family Finances by Hayhoe, C., Jamison, S. Dillard, A. F., and Chase, M.

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