College Saving Plan

A good rule of thumb when investing for college is to give greater priority to your retirement savings than to college savings. There are two reasons for this:

1. First, the student has resources to draw on besides you to help pay for college, but your client can't get a scholarship to retire, and
2. Second, many parents have only a few years to save for retirement, once the last child graduates. Considering the number of children they may have to educate and the high price of college, they may be better off to borrow for college than neglect their retirement goals.

Everybody assumes that QTPs are the best way to save for college. In reality, this may not be the case. It just depends on the family's financial goals and objectives. Every family has different circumstances from which they must make the final determination on which investment account is best.

Qualified Tuition Programs

What is a Qualified Tuition Plan?

A qualified tuition program (also known as a 529 plan or program) is a program set up to allow a person to either prepay or contribute to an account established for paying a student's qualified education expenses at an eligible educational institution.

Each QTP is unique. QTPs can be established and maintained by states (or agencies or instrumentalities of a state) and eligible educational institutions. The program must meet certain requirements. Each state government or the eligible educational institution in which a person is interested in can tell them whether or not they participate in a QTP. Information on the QTP account activity is sent through a statement to its participants

The owner of the QTP account must also meet certain requirements. The owner must be of legal age, and either a U.S. citizen or a resident alien of the U.S.

Types of QTPs

- **Prepaid Tuition Plans**

A prepaid tuition plan is a QTP in which persons may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary.

These state-operated trusts offer residents a hedge against tuition inflation. States offer contracts whereby they agree to pay future tuition at in-state public institutions at prices pegged to the current tuition levels. Some state contracts incorporate a further discount derived from a share of the program trust fund's projected future investment gains in excess of anticipated tuition increases. While prepaid tuition plans are designed to eliminate the risk of tuition inflation, some sponsoring states do not guarantee the contract. This means that in a worst-case scenario, a poor investment climate combined with a lack of accumulated reserves could threaten the solvency of a program trust fund.

Contracts in these programs are almost always "portable," in that the cash value of the contract may be applied to expenses at a private or out-of-state institution.

- **College Savings Plans**

A college savings plan is a type of QTP under which persons may make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account.

Essentially a state-sponsored mutual fund, the basic idea of a savings plan is that the account owner's contribution will grow in value over time, keeping up with or surpassing the escalating price of a college education. Inherent in savings plans, however, is the risk that the underlying investments may not keep pace with tuition increases. Many savings plans manage this risk by investing the accounts more conservatively as the designated beneficiary approaches college age. Withdrawals are taken as needed to pay for the designated beneficiary's college expenses.

Most new QTPs are savings plans; these are generally judged superior to prepaid tuition plans. Savings plans offer more flexibility than prepaid tuition plans, and their investment approach can provide upside potential from the stock market. Several states have plans that are open to residents and nonresidents alike.

Qualified Education Expenses

These expenses are the tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution.

The definition of qualified education expenses was expanded to include expenses of a special needs beneficiary that are necessary for that person's enrollment or attendance at an eligible educational institution.

Designated Beneficiary

The designated beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The designated beneficiary can be changed after participation in the QTP begins. If a state or local government or certain tax-exempt organizations purchase an interest in a QTP as part of a scholarship program, the designated beneficiary is the person who receives the interest as a scholarship.

The designated beneficiary does not have control over the QTP account, it is the account owner that has control over the timing and use of the withdrawal. However, the value of the QTP account is not included in the account owner's gross estate, it is included in the estate of the designated beneficiary.

Eligible Educational Institution

For purposes of a QTP, this is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell the inquiring party if it is an eligible educational institution.

Contributions

Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary, but there is no annual federal contribution limitation, The maximum contribution allowance is determined by each state. There are no income restrictions on the individual contributors.

A person can contribute to both a QTP and a Coverdell ESA in the same year for the same designated beneficiary.

For contributions made by a donor on behalf of the beneficiary that are in excess of the $14,000 annual exclusion amount, a special election is available that permits the contribution to be treated as if it were made ratably over a five-year period.

Investing in QTPs

The account owner has no direct control over how the funds are invested within the QTP. The account owner, when setting up the account, will have to choose the investment strategy that would best suit their needs that the plan offers. If one has a beneficiary who will be attending school in the long-term, they may prefer a more aggressive strategy and invest primarily in equity funds.

The cost of investing in a QTP will usually be higher than the cost of investing directly in the mutual funds that are found in most QTPs.

Are Distributions Taxable?

The part of a distribution representing the amount paid or contributed to a QTP does not have to be included in income. This is a return of the investment in the plan.

The designated beneficiary generally does not have to include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified education expenses.

Financial Aid Effects

QTPs can be regarded as an asset of the parent if the parent is the owner of the account, rather than the student, and thereby displace a smaller amount of financial aid. Distributions from QTPs that are not subject to federal income tax are not counted as parent or student income in the determination of federal financial aid eligibility. Distributions for qualified educational expenses therefore do not reduce financial aid eligibility.

Earnings and Return of Investment

The taxpayer will receive a Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530), from each of the programs from which they received a QTP distribution in 2012. The amount of the gross distribution (box 1) shown on each form will be divided between the earnings (box 2) and the basis, or return of investment (box 3). Form 1099-Q should be sent by February 1, 2014.

Figuring the Taxable Portion of a Distribution

To determine if total distributions for the year are more or less than the amount of qualified education expenses, the total of all QTP distributions for the tax year must be compared to the adjusted qualified education expenses.

Adjusted Qualified Education Expenses

This amount is the total qualified education expenses reduced by any tax-free educational assistance. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships
- Veteran's educational assistance
- Pell grants
- Employer-provided educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Taxable Earnings

Use the following steps to figure the taxable part.

1. Multiply the total distributed earnings shown on Form 1099-Q (box 2) by a fraction. The numerator is the adjusted qualified education expenses paid during the year and the denominator is the total amount distributed during the year.
2. Subtract the amount figured in (1) from the total distributed earnings. This is the amount the beneficiary must include in income. Report it on line 21, Form 1040.

Coordination With American Opportunity and Lifetime Learning Credits

An American Opportunity or Lifetime Learning credit (education credit) can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP, as long as the same expenses are not used for both benefits. This means that after the beneficiary reduces qualified education expenses by tax-free educational assistance, he or she must further reduce them by the expenses taken into account in determining the credit.

Losses on QTPs

If the investor has a loss on their investment in a QTP account, they may be able to take the loss on their income tax return. The investor can take the loss only when all amounts from that account have been distributed and the total distributions are less than their un-recovered basis. The basis is the total amount of contributions to that QTP account. The investor may claim the loss as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040), subject to the 2%-of-adjusted-gross-income limit.

If the investor has distributions from more than one QTP account during a year, they must combine the information (amount of distribution, basis, etc.) from all such accounts in order to determine the taxable earnings for the year. By doing this, the loss from one QTP account reduces the distributed earnings (if any) from any other QTP account.

Additional Tax

Generally, if the investor receives a taxable distribution, they also must pay a 10% additional tax on the amount included in income.

Exceptions

The 10% additional tax does not apply to distributions:

1. Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.
2. Made because the designated beneficiary is disabled. A person is considered to be disabled if he or she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that his or her condition can be expected to result in death or to be of long-continued and indefinite duration.
3. Included in income because the designated beneficiary received: a) A tax-free scholarship or fellowship b) Veterans' educational assistance c) Employer-provided educational assistance d) Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.
4. Made on account of the attendance of the designated beneficiary at a U.S. military academy (such as West Point). This exception applies only to the extent that the amount of the distribution does not exceed the costs of advanced education (as defined in title 10 of the U.S. Code) attributable to such attendance.
5. Included in income only because the qualified education expenses were taken into account in determining the Hope or Lifetime Learning credit.
6. Made before 2004 and used for qualified education expenses, but included in income because it was paid from a QTP established and maintained by an eligible educational institution.

Exception (3) applies only to the extent the distribution is not more than the scholarship, allowance, or payment.

Rollovers & Transfers

Assets can be rolled over or transferred from one QTP to another. The designated beneficiary can be changed or the beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

Rollovers

Any amount distributed from a QTP and rolled over to another QTP for the benefit of the same beneficiary or for the benefit of a member of the beneficiary's family (including the beneficiary's spouse) is not taxable and may be done only once in a 12-month period. An amount is rolled over if it is paid to another QTP within 60 days after the date of distribution. A rollover involving a change of beneficiary to another member of the original beneficiary's family may be transacted at any time, and is not considered a completed gift.

Members of the Beneficiary's Family

For these purposes, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary.

1. Son or daughter or descendant of son or daughter
2. Stepson or stepdaughter
3. Brother, sister, stepbrother, or stepsister
4. Father or mother or ancestor of either
5. Stepfather or stepmother
6. Son or daughter of a brother or sister
7. Brother or sister of father or mother
8. Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
9. The spouse of any individual listed above
10. First cousin

The gift tax situation should be checked on before the taxpayer decides to complete deals with QTPs and rollovers or beneficiary changes. Such changes that involve beneficiaries who are members of the same family [as defined in IRC Sec. 529(e)(2)] and in the same generation pose no gift tax issues.

However, if the QTP is rolled over to a beneficiary who is in a generation lower than that of the old beneficiary, a new rule applies. The old beneficiary (rather than the QTP owner) is treated as having made a taxable gift to the new beneficiary, regardless of whether the y are family members. The generation-skipping transfer tax also applies in this situation when the newly named beneficiary is two or more generations lower.

Changing the Beneficiary

There are no tax consequences if the designated beneficiary of an account is changed to a member of the beneficiary's family.