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## Tax Advantages Can Stretch Your Education Dollars

The cost of a higher education has increased by 439% since 1982, while median family income rose 147%, according to a study from the National Center for Public Policy and Higher Education (The National Report Card) released in December 2008. To reduce this huge burden, many families are turning to tax-advantaged savings accounts for help. Contributions to such plans are not deductible; however, taxes on growth and earnings in them are deferred and can be avoided altogether when the funds are used for qualified education expenses. Congress has created several tax-preferred paths for education funding.

### Coverdell Education Savings Account (CESA)

Up to \$2,000 may be set aside each year for a student's future education expenses. That annual limit applies on a per child basis. For example, if parents and grandparents want to contribute to a child's CESA, they will have to coordinate their gifts so as not to exceed the \$2,000 limit. There is also an income limit for the donors. To make a maximum \$2,000 contribution, the donor's income cannot exceed \$110,000 for a single taxpayer (\$220,000 for marrieds filing jointly). Once the child reaches age 18, CESA contributions are not permitted.

Distributions that are used to pay qualified education expenses are excluded fully from additional income tax. Money not used is potentially taxable, and a 10% penalty tax will apply. Funds must be distributed by the time the beneficiary reaches age 30. However, a rollover to a CESA for another family member, such as a younger brother or sister, is permitted. A donation to a CESA is a completed gift, which will be protected from the gift tax by the annual gift tax exclusion (\$13,000 in 2009).

### Section 529 Plan

A Section 529 plan is a state-sponsored savings or investment account set up for the purpose of saving in

order to pay for most higher education expenses, such as tuition, room, board, and supplies. There is no income limit on the donors. Maximum contributions are set by state and vary but are usually at least \$100,000 per plan beneficiary. Earnings accumulated are tax-deferred, and distributions used for qualified education expenses are tax-free, just as with CESAs.

Investment management is controlled by the plan. The donor may choose from funds with a range of risk and reward characteristics and, typically, may alter that choice just once each year. Some plans offer funds that automatically shift to more conservative investments as the child approaches college age. With 529 plans, as with investing in mutual funds, the donor will want to make a thorough investigation before committing any funds.

### Independent 529 Plan

An alternative to saving for college is prepaying those expenses years in advance. Funds that are contributed to Independent 529 plans are a tuition prepayment for any of the participating schools. The percentage of prepayment will not be the same for each school, but will be geared to that school's current tuition rates. If the student does not go to college, or chooses a nonparticipating school, contributions will be refunded, subject to a maximum rate of return of 2% (up or down) compounded annually.

### Which is Best for You?

There are, of course, pros and cons to each of the alternatives available to you. For instance, one also needs to take into account other tax benefits, such as the Hope and Lifetime Learning Credits. Contact a qualified professional for more information about these plans and other options.