3/31/14

Tax-Savvy Planning for College Expenses

The American Opportunity Tax Credit Remains Available through 2017

If you are a parent with hopes of future college diplomas for your children, you are likely considering a financial plan to fund higher education costs. Once the children are attending college, your priorities may then transition to strategies for paying current or imminent bills. There are several approaches you can take to maximize the tax benefits and to minimize your expenses for both objectives.

Caution: *The American Opportunity tax credit, discussed below, is available through 2017, however, absent further legislation, the rules relating to credits for higher education expenses apply for tax years beginning after Dec. 31, 2017.*

Please note that the following approaches are strictly related to tax benefits. You may have non-tax-related concerns that make an approach inappropriate for you.

College Savings Options

Transferring Ownership of Assets

In some cases, transferring ownership of assets to children can save taxes. You and your spouse can transfer up to $28,000 (in 2014) in cash or assets to each child with no gift tax consequences. If your child isn't subject to the “kiddie tax*,” he or she is taxed on income from assets entirely at his or her likely lower tax rate — as low as 10% (or 0% for long-term capital gain). However, where the kiddie tax applies, the child's investment income above $2,000 (for 2014) is taxed at *your* tax rate, not the child's rate.

* The kiddie tax applies if:

- The child hasn't reached age 18 before the close of the tax year **or**
- The child's earned income doesn't exceed one-half of his or her support **and**
    a. the child is age 18 **or**
    b. the child is a full-time student age 19 to 23.

You can use a variety of trusts or custodial arrangements to place assets in your children's names. However, it's not enough to transfer the income, such as dividend checks, to your children — the income would then still be taxed to you. You must transfer the asset that generates the income to their names.

Tax-exempt bonds

Another way to achieve economic growth while avoiding tax is simply to invest in tax-exempt bonds or bond funds. Interest rates and degree of risk vary on these, so care must be taken in selecting your particular investment. Some tax-exempt bonds are sold at a deep discount from face value and don't carry interest coupons; many are marketed as college savings bonds. A small investment in these so-called zero-coupon bonds can grow into a fairly sizable fund by the time your child reaches college age. “Stripped” municipal bonds (munis) provide similar advantages.

Series EE U.S. savings bonds

Series EE U.S. savings bonds offer two tax-savings opportunities when used to finance your child's college expenses:

- You don't have to report the interest on Series EE bonds for federal tax purposes until the bonds are actually cashed in.
- Interest on “qualified” Series EE (and Series I) bonds may be exempt from federal tax if the bond proceeds are used for qualified college expenses.

To qualify for the tax exemption for college use:

- You must purchase the bonds in your own name (not the child's) or jointly with your spouse.
- The proceeds must be used for tuition, fees, etc., not room and board. If only part of the proceeds is used for qualified expenses, then only that part of the interest is exempt.

If your adjusted gross income (AGI) exceeds certain amounts, the exemption is phased out. For bonds cashed in during 2014, the exemption begins to phase out when AGI hits $113,950 for joint return filers ($76,700 for singles) and is completely phased out if your AGI reaches $143,950 ($91,000 for singles).

Qualified tuition programs (529 plans)

A qualified tuition program, also known as a 529 plan, allows you to buy tuition credits for a child or make contributions to an account established for a child's future higher education expenses. Qualified tuition programs may be offered by state governments or by private educational institutions. Note that you are not restricted to your state’s plan — if you won’t realize any tax benefits from your state, it may pay to compare the features of other plans.

Contributions to qualified tuition programs aren't deductible. The contributions are treated as taxable gifts to the child, but they are eligible for the annual gift tax exclusion ($14,000 for 2014). A donor who contributes more than the annual exclusion limit for the year can elect to treat the gift as if it were spread out over a five-year period.

The earnings on contributions to qualified tuition programs accumulate tax-free until the college costs are paid from the funds. Distributions are tax-free to the extent the funds are used to pay qualified higher education expenses; however, distributions of earnings that aren't used for qualified higher education expenses will be subject to income tax plus a 10% penalty tax.

Coverdell education savings accounts (Coverdell ESAs)

You can establish Coverdell ESAs (formerly called education IRAs) and make total contributions of up to $2,000 per year for each child under age 18. This age limitation doesn't apply to a beneficiary with special needs, defined as an individual who because of a physical, mental or emotional condition, including learning disability, requires additional time to complete his or her education.

The right to make contributions begins to phase out once your AGI exceeds $190,000 on a joint return ($95,000 for singles). If the income limitation is an issue for your family, consider whether your child can make a contribution to his or her own account.

Although contributions to a Coverdell ESA aren't deductible, income in the account isn't taxed, and distributions are tax-free if spent on qualified higher education expenses — or on qualified elementary or secondary education expenses, an attractive benefit to parents who start saving when their children are very young. Any unused funds must be withdrawn by the time the child turns 30, at which point any earnings will be subject to tax and penalty unless the funds are transferred tax-free to a Coverdell ESA of another member of the child's family who hasn't reached age 30. Again, the age requirements do not apply to individuals with special needs.

Paying for College Expenses

You may be able to take a credit for some of your child's college tuition expenses — in fact, following enactment of recent legislation, you may still have an option you had previously given up for lost. There are also tax-advantaged ways of getting your child's college expenses paid by others.

Tuition tax credits

Tuition tax credit availability varies by academic period covered, a taxpayer's income, and other credits taken, among other factors. Two types of tuition tax credits are:

- The American Opportunity tax credit: Take up to $2,500 per student for the first four years of college (a 100% credit for the first $2,000 in tuition, fees, and books, and a 25% credit for the second $2,000).

- The Lifetime Learning tax credit: Take up to $2,000 per family for every year of college or graduate school (a 20% credit for up to $10,000 in tuition and fees).

If you claim the American Opportunity credit for a given student you may not claim a Lifetime Learning credit for any of that same student's expenses in the same tax year. However, you may claim either type of credit for a tax year and also exclude from gross income amounts distributed (both principal and earnings) from a Coverdell ESA for the same student, as long as the distribution isn't used for the same educational expenses for which a credit was claimed.

The American Opportunity tax credit is 40% refundable, meaning that if the amount of the credit is more than the tax you owe, up to 40% of the credit (a maximum of $1,000) may be refunded to you. For example, if you have at least $4,000 in qualified expenses and would thus qualify for the maximum credit of $2,500, and have no tax liability against which to offset that credit, you would qualify for a $1,000 refund from the government (40% of $2,500 = $1,000).

Both types of credit are phased out for higher-income taxpayers. The American Opportunity tax credit is phased out:

- For couples with income between $160,000 and $180,000
- For singles with income between $80,000 and $90,000.

The Lifetime Learning credit phase-out ranges are adjusted annually for inflation. For 2014 these are:

- For couples with income between $108,000 and $128,000
- For singles with income between $54,000 and $64,000.

The American Opportunity tax credit was set to expire at the end of 2012, but has been extended through December 31, 2017 by the American Taxpayer Relief Act of 2012.

Scholarships

Scholarships are exempt from income tax, if certain conditions are satisfied. The most important are that the scholarship must not be compensation for services, and it must be used for tuition, fees, books, supplies, and similar items — but not for room and board.

Although a scholarship is tax-free, it will reduce the amount of expenses that may be taken into account in computing the American Opportunity and Lifetime Learning credits, above, and may therefore reduce or eliminate those credits.

In an exception to the rule that a scholarship must not be compensation for services, a scholarship received under a health professions scholarship program may be tax-free even if the recipient is required to provide medical services as a condition for the award.

Employer educational assistance programs

If your employer pays your child's college expenses, the payment is a fringe benefit to you. As such it is taxable to you as compensation, unless the payment is part of a scholarship program that is “outside of the pattern of employment” (as defined by Internal Revenue Code Section 117). In this case the payment will be treated as a scholarship, providing the other requirements for scholarships are satisfied.

Tuition reduction plans for employees of educational institutions

Some tax-exempt educational institutions provide tuition reductions for their employees' children who attend that educational institution, or cash tuition payments for children who attend other educational institutions. If certain requirements are satisfied, these tuition reductions are exempt from income tax.

College expense payments by grandparents and others

If someone other than you pays your child's college expenses, the person making the payments is generally subject to the gift tax, to the extent the payments and other gifts to the child by that person exceed the regular annual gift tax exclusion, which is $14,000 per donee for 2014. Married donors who consent to split gifts may exclude gifts of up to $28,000 for 2014.

However, if a person other than you pays your child's tuition directly to an educational institution, there is an unlimited exclusion from the gift tax for the payment. This exclusion applies only to direct tuition costs; there is no exclusion (beyond the normal annual exclusion) for dormitory fees, board, books, supplies, etc. Prepaid tuition payments may qualify for the unlimited gift tax exclusion under certain circumstances.

While the relationship between the person paying the tuition and the person on whose behalf the payments are made is irrelevant, typically the payer is a grandparent.

Student loans

You can deduct interest on loans used to pay for your child's education at a post-secondary school, including some vocational and graduate schools. (This is an exception to the general rule that interest on student loans is personal interest and, therefore, not deductible.) The deduction is an above-the-line deduction, meaning that it's available even to taxpayers who don't itemize. The maximum deduction is $2,500, however, the deduction phases out for taxpayers who are married filing jointly with AGI between $125,000 and $155,000 (between $60,000 and $75,000 for single filers).

Generally, if a loan or other debt you owe is canceled, you must report the cancellation as income. However, student loans provide for exceptions to this general rule. Some student loans contain a provision that all or part of the loan will be canceled if the student works for a certain period of time in certain professions for any of a broad class of employers — e.g., as a doctor for a public hospital in a rural area. The student isn’t required to report income if the loan is canceled and he or she performs the required services. There's also no income to report if student loans are repaid or forgiven under certain federal or state programs for health care professionals.

Bank loans

The interest on loans used to pay educational expenses is personal interest which is generally not deductible (unless you qualify for the deduction for education loan interest, described above). However, if the loan is “home equity indebtedness,” and interest on the loan is “qualified residence interest,” the interest is deductible for regular income tax purposes, although not for alternative minimum tax purposes. If interest is deductible as qualified residence interest, it can't be deducted as education loan interest.

Borrowing against retirement plan accounts

Many company retirement plans permit participants to borrow cash. This option may be an attractive alternative to a bank loan, especially if your other debt burden is high. However, the loan must carry an interest rate equal to the prevailing commercial rate for similar loans, and, unless you qualify for the deduction for education loan interest (described above), there's no deduction for the personal interest paid. Moreover, unless strict requirements are satisfied, a loan against a retirement account is treated as a premature distribution (withdrawal) that's subject to regular income tax and an additional penalty tax.

Withdrawals from retirement plan accounts

IRAs and qualified retirement plans represent the largest cash resource of many taxpayers. You can withdraw money from your IRA (including a Roth IRA) at any time to pay college costs without incurring the 10% early withdrawal penalty that usually applies to distributions taken before age 59½. However, the withdrawals are subject to tax under the usual rules for IRA distributions.

Some qualified retirement plans may prohibit or restrict early withdrawals. For example, a 401(k) cash-or-deferred plan may allow distributions if the participant has an immediate and heavy financial need and lacks other resources to meet that need. IRS regulations identify a college education as such a need. To the extent they represent previously untaxed dollars and earnings, amounts withdrawn from a retirement plan are fully subject to tax, as well as a 10% penalty tax if they are made before the participant reaches age 59½. (Note, however, that you cannot roll over a 401(k) plan "hardship" distribution into an IRA to set up a later penalty-free withdrawal to pay college costs.)

A younger plan participant may avoid triggering the penalty tax by taking annuitization payouts from an IRA or a SEP. The strategy works because the penalty tax doesn't apply if annual or more frequent withdrawals are made in substantially equal payments over the life or life expectancy of the taxpayer (or the joint lives or joint life expectancies of the taxpayer and designated beneficiary). This method doesn't work for 401(k) type plans.

The Most Effective Tax Strategies Require Careful Planning

The above are just some of the tax-favored ways to build funds and plan for expenses for your college-bound children. Not all of the tax breaks described may be used in the same year, and using some breaks will reduce the amounts that qualify for others. As well, some rules vary depending on when your children will attend college. Thus, it takes careful planning to determine which strategy is best for your specific situation.

~

If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

About Seiler LLP

Established in 1957, Seiler is a leading accounting firm serving affluent clients, closely held businesses and non-profit organizations throughout the United States and the world. From our offices in San Francisco and the Silicon Valley, we offer highly sophisticated solutions and innovative thinking in the areas of tax and estate planning, charitable gift planning, audit and assurance, real estate, family office and litigation support. At Seiler, our mission is to provide the knowledgeable advice and guidance our clients require to navigate the complexities of their financial worlds not only today, but also for the many years to come. For more information, please visit www.seiler.com.

Silicon Valley Office
Three Lagoon Drive, Suite 400
Redwood City, CA 94065
Main: 650.365.4646
info@seiler.com

San Francisco Office
220 Montgomery Street, Suite 300
San Francisco, CA 94104
Main: 415.392.2123
info@seiler.com

Named a “Top 100 Accounting Firm” in the U.S. by *INSIDE Public Accounting Magazine*

Named a "Best of the Best Top Accounting Firm" in the U.S. by *INSIDE Public Accounting Magazine*

IRS Circular 230 Disclosure:
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Privilege Disclaimer:
The information transmitted is intended only for the person or entity to which it is addressed and may contain confidential and/or privileged material. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information by persons or entities other than the intended recipient is prohibited. If you received this in error, please contact the sender and delete the material from any computer.

© 2014, Seiler LLP

This content is for general information purposes only, and should not be used as a substitute for consultation with professional legal, tax or accounting advisors.