Plan For College Now; Reduce Stress Later

With the ever-increasing cost of education in this country, one of the most prominent thoughts of any parents is how they will pay for their children to attend college. However, there are ways to begin planning early that will lead to an income stream for education expenses when the time for college arises.

Instead of waiting until the child is 18 and ready to ship off to school, there are options available to plan for that day throughout the child's upbringing.

One common technique to use for educational expenses planning is the creation of a 529 Plan for a benefit of a child or grandchild. 529 Plans vary by state with some making more sense than others. The way it works is by making contributions to the plan after taxes are considered. The contributions then grow free of federal income tax burden for the benefit of the child of grandchild named as beneficiary of the plan. There is no risk that the goal of education will not be met as the funds must be used for college tuition and related expenses (technically they can be used otherwise, but will be subject to a penalty on the account earnings). If the original beneficiary of the plan does not use all of the funds for his or her education, then most of the time the beneficiary can be changed to another child in order to use up all the funds. 529 Plans are limited in that they only can provide for higher education expenses.

An alternative to a 529 Plan is the creation of an irrevocable gifting trust. Many people assume that trust funds are only associated with the super wealthy, however there is no requirement that any minimum amount must be contributed. Understanding the concept of a trust can do wonders for a family with some proper planning. If education is the goal, an irrevocable trust can be set up with children or grandchildren as the beneficiaries. A trust has an added benefit over a 529 Plan in that it can make distributions to the beneficiary (i.e. a child or grandchild) not only for college, but for other educational needs, health, maintenance, support or any other legitimate reasons, such as a down payment on a house or to start a business. There are numerous techniques that can be used by your attorney to ensure that you maintain maximum control over how the assets are disbursed. The major disadvantage to the gifting trust when compared to the 529 Plan is that the funds in the trust do not grow income tax free. Each year, to the extent income is not distributed; the trust will be required to pay income tax on its earnings.

There is also the option to combine the above two mechanisms in order to, in a sense, get the best of both worlds. An irrevocable education trust could be set up with the parents (or grandparents) putting cash into the trust (if done in appropriate amounts annually, this can be done free of gift tax). The trustee would then open 529 Plans for the beneficiaries using the cash in the trust with the trust as the account owner and the trust beneficiary as the 529 Plan beneficiary. The trustee could then authorize qualified distributions from the 529 Plan to the beneficiary for higher education expenses.

Some benefits of this hybrid approach are automatic succession planning, the limitation on the diversion of funds, the ability to fund education for a class of beneficiaries, and protection from creditors. A trust owned 529 Plan limits the need for succession planning because the successor trustee would automatically become the successor account owner. Additionally, fiduciary duties would prevent the trustee from making a distribution to himself individually so there is minimal opportunity for funds to be diverted from their intended purpose in a trust-owned 529 Plan. A trust can be set up for a class (all children or grandchildren) with the intent that if one member of the class does not use all of the funds for his or her education, the beneficiary on the account can be changed to another member of the class who is incurring greater education costs, whereas a 529 Plan with unused funds would face the possibility of paying a penalty for non-qualified distributions. The trust can contain specific instructions directing the trustee to use the trust-funds principally for higher education even if distributions among the beneficiaries are therefore unequal. Finally, the trust may contain a spendthrift clause that protects the trust assets from the beneficiary's creditors, so even if state law does not protect the 529 Plan from creditors, then trust can.

Like anything else, the hybrid approach outlined above also has some disadvantages, mostly centered on tax issues that are beyond the scope of this post. However, your attorney should be able to advise on how to appropriately handle these issues to minimize impact.

With a little planning early on in your child's life you can alleviate a lot of the stress associated with thinking about how to pay for higher education. When planning, it is important to consider 529 Plans and their tax benefits and compare them to the advantages of a gifting trust's flexibility to make a wider range of distributions. A little planning now really does have the potential to lead to peace of mind later.

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