College Savings Options

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With the cost of college tuition increasing at approximately twice the general rate of inflation, determining the best method to save for college is an important decision for those with young children or grandchildren. There are many options available for creating an account for education expenses.

529 Plans

In 1996, Congress created the "529 plan" which enjoys many tax and non tax advantages as a college savings vehicle. Michigan's 529 plan is called the "Michigan Education Savings Program." Its specific characteristics include:

Earnings: The account earnings build up income tax-free. Earnings which are used to pay qualified education expenses are also free of federal and state income tax.

Tax Deduction: Michigan taxpayers may be eligible for a Michigan income tax deduction when making contributions to the account. The contribution deadline is December 31.

Gift Tax: Gifts to a 529 account qualify for the $13,000-per-year gift tax exclusion and a donor may elect to treat a contribution of up to $65,000 as being made over 5 years (which requires the filing of a gift tax return). Although the excess amount is subject to gift tax, the Michigan Education Savings Program allows contributions up to $235,000 per beneficiary.

Use of Funds: Funds are available for any eligible higher educational institution in the nation, and many abroad. If funds are withdrawn for ineligible expenses, they are subject to income tax and incur a 10% penalty on the earnings portion.

Changing Beneficiary: If the beneficiary does not use all of the funds, another eligible beneficiary (a member of the previous beneficiary's family) may be named for the account with no gift or adverse income tax consequences.

Income Limitations: None.

Estate Tax: Amounts contributed to a 529 are not included in the donor's estate.

These accounts may be set up directly through the state of Michigan or with a financial adviser.

Michigan Education Trust

Another savings plan available in Michigan is the “Michigan Education Trust.” This is a prepaid tuition plan that allows an individual to pay for future education expenses at discounted rates. Funds withdrawn for qualified higher education expenses are free of federal income tax. Funds can be used only for tuition and fees and may lose some of their value if used for a private or non-Michigan school. The donor may receive an income tax deduction for the amount of his/her contribution. If the funds are not used by the beneficiary before age 30, they can be rolled to another qualified beneficiary.

Coverdell Education Savings Account (ESA)

A Coverdell ESA allows funds to be set aside for elementary, secondary or higher education tuition and expenses (very broadly defined). Withdrawals are tax-free if used for qualified educational expenses, and if properly coordinated with the use of available federal education tax credits. The contribution amounts are limited to $2,000 per year per child (including contributions from others). The contribution amount is also limited by an individual’s income. The funds must be distributed by the time the beneficiary reaches age 30, unless he or she has special needs. A contribution can be made, effective for the prior year, if made by the due date of the donor’s income tax return (not including extensions). Unless Congress acts (again), certain ESA benefits expire after 2012. K-12 expenses will no longer qualify, the annual contribution limit will be reduced to $500 and withdrawals will not be tax-free in any year in which a Hope credit, Lifetime credit or Lifetime Learning credit is claimed for the beneficiary.

U.S. Savings Bonds

Under certain conditions, interest is excluded from federal taxes when a U.S. savings bond is redeemed and used to pay college expenses (tuition and fees only). However, this exclusion is designed for parents meeting certain income requirements and purchasing bonds in their own names. Bonds purchased by grandparents hardly ever meet those conditions. The exclusion from income is phased out based on the taxpayer’s income.

UTMA or UGMA accounts

These assets are typically owned by the child’s parent as “custodian” for the benefit of a minor child. The moneys in the account can be used for the benefit of the child, so long as the expenses aren’t “parental obligations” or otherwise benefit the custodian. Income from the account is taxable to the child, and may be subject to the “kiddie-tax” rules. When the child reaches age 18 (for UGMA) or 21 (for UTMA), the funds in the account become owned directly by the child.

Although there are a number of options available for funding a college savings account, each has its own unique features to be considered. For those considering increasing their gifting in this year to take advantage of the $5 million estate and gift tax exclusion, creation of a college savings fund may be an appropriate vehicle. Contact your Warner Norcross estate planning attorney if you would like additional information on these options