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WHITEPAPER | September 2020

How Do Savvy Investors Reap Tax & Estate Planning Benefits While Planning for (Post-Secondary) Education Expenses?

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There is a changing reality for many parents: that advanced planning and a long-term strategy for financing a child's education are becoming more of a necessity than a luxury, even for families of significant means.

Education funding is one of the largest expenditures most American families will undertake, and costs continue to grow, far outpacing inflation. Today, average costs for just tuition and fees, not including room and board, exceed $36,880 per year for private schools, and $10,440 for in-state residents (or $26,820 for out-of-state residents) attending public schools.[1]

Funding four years of college, or potentially more, requires forethought, and savvy families need to consider how they will pay for post-secondary education, potentially including both college and graduate school. The best chance we see for a successfully executed savings plan includes getting started well in advance and harmoniously incorporating the right mix of strategies. Some families can reap significant tax and estate planning benefits. The nuances can be complex, but many families can employ opportunities for generational wealth transfer.

GETTING STARTED: COMMON TYPES OF EDUCATION SAVINGS ACCOUNTS

Setting up college savings accounts to benefit a child can be done in several ways, the most common being 529 savings plans. Named for Internal Revenue Service Code 26 U.S.C. § 529, these tuition plans are sponsored by states or educational institutions. Custodial accounts, or Uniform Transfers to Minors Act (UTMA) accounts, are also common and offer different benefits.

529 Plans - Anyone can open a 529 plan–a parent, grandparent, guardian, aunt, uncle, neighbor or friend–but in some states the account owner may not be entitled to the full tax benefits unless the beneficiary is a dependent, which we'll discuss later in this article. Whoever opens the 529 account is the owner and remains in control of the funds even after a beneficiary reaches the age of majority. The major benefit of a 529 plan is that growth on investments is tax free, with most states offering additional benefits in their plans (such as in-state tax deductions). An owner can also change beneficiaries to another family member of the beneficiary (or even themselves when related to the beneficiary). Funds held in a 529 account may be withdrawn and used for qualified post-secondary education expenses and, with recent tax law changes, K-12 expenses (with limitations), otherwise taxes and penalties may be incurred. It is important to note that, when registered in a parent's name, 529 plan assets are considered parental assets from a FAFSA (Free Application for Federal Student Aid) perspective.

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UTMA - For UTMAs, the child receives full ownership of the account upon reaching the age of majority (between age 18 and 21 depending on the state of residency). The gains realized within an UTMA are taxable and are taxed utilizing trust tax brackets (this is another change associated with the Tax Cuts and Jobs Act of 2017) so, if not handled thoughtfully, accessing these funds can have the potential to be expensive. At the same time, one major benefit is that funds from UTMA accounts can be used more flexibly for non-educational expenses.

CONTRIBUTION AND DEDUCTION LIMITS FOR 529 PLANS

The total amount contributed to a 529 plan for each beneficiary is defined by the plan; each state has a set cap ranging from $235,000 in Mississippi to $529,000 in California. In addition to the total allowable contribution, most states limit the state tax benefits. For example, an account owner who lives in the state of Wisconsin can take a state tax deduction of $3,340 per beneficiary per year. Those who contribute more can carry forward the amount to future years. Some states allow significantly more or may allow a state tax deduction for contributions to another state's plan. For example, Colorado allows you to take a deduction up to the amount of your full taxable income, while Pennsylvania allows for a deduction for a contribution to any state plan.

Should a family decide to move to another state, many states will allow them to "rollover" the account to the new state plan. This can present a huge tax benefit for families when states allow it; however, the prior state may seek to recapture the state tax deduction.

As mentioned above, the Tax Cuts and Jobs Act, passed in late 2017 and effective starting in 2018, includes a provision allowing families to use 529 plans for up to $10,000 of K-12 expenses. It is important to understand how each state handles these types of withdrawals to ensure that distributions for these purposes does not cause adverse outcomes (such as a recapture of previous state tax deductions). Families considering using 529 plans for primary or secondary school should also reconsider the time horizon and investment profile of their 529 accounts.

CONTRIBUTING TO EDUCATION AS A GRANDPARENT

Grandparents who plan to contribute to their grandchildren's education should keep a few things in mind. Money a child receives from a 529 account registered to a grandparent (or anyone other than their parents) is considered income to the child from a FAFSA perspective and thus counts against financial aid formulas.

To avoid having the benefit of this generous gift offset by the FAFSA reduction, a grandparent can consider several other strategies:

- Encourage grandchildren to use funds from the 529 account in the later years of their education. This will prevent the gift from interfering with factors on which the FAFSA is based (since FAFSA asks for information based on two prior years).
- Deposit the funds into a Uniform Gifts to Minors (UGMA) account or other account owned by the parent for the benefit of the grandchild. Gifters should keep in mind that this strategy may prevent the contributions from being tax deductible unless the state allows tax deductions on deposits into accounts owned by other people, and/or if the grandparents live in the same state, or a state which allows for deductions for contributions to other state plans.
- Gifting the funds to the grandchild's parents and having the parents make a deposit into a 529 account. This strategy is beneficial in instances when the parents are not already making contributions that realize the maximum state deduction and have a higher state tax rate than the grandparents.

USE EDUCATION GIFTING AS AN ESTATE PLANNING STRATEGY

In addition to the future benefits created by education savings, a family's savings efforts can also aid in reducing a taxable estate. While 529 contributions are subject to the annual gift exemption (currently $15,000/$30,000 for couples in 2020), gifts can be "front loaded" or given all at once to meet a maximum over multiple years. For example, a one-time gift of $75,000 would cover 5 years of maximum contributions, but the additional compounding interest in that account would not be subject to a gift tax.

One caveat: contributions to a 529 plan above the annual gift tax exclusion are allowed and there is the option to average the gift over 5 years. For example, for a gift of $40,000 in 2020, a family is allowed to spread the gift $8,000/year over five years, not two. There would be room for other gifts toward the exemption in the intervening years; however, it is important to be cognizant of what happens if you exceed the annual gift limit. Excess gift amounts will then count against your lifetime limit, currently $11.58 million for an individual or $23.16 million for a couple, and if that is exceeded, be subject to taxes.

College tuition paid directly to the institution is also not subject to the annual gifting exemption. An affluent individual looking

to avoid gifting limitations like those mentioned above could simultaneously pay tuition expenses directly to the institution and gift to a 529 plan at the maximum rate. This combination of strategies is most helpful to those looking to reduce their estate by more than the amount subject to the gift tax, and can reduce the need for the 529 funds on the part of the named beneficiary. This way, the money contributed to a 529 account can grow tax deferred and be passed on to later beneficiaries, even those in the next generation.

Consider this example: A grandparent could set up ten 529 accounts, one for each of their 10 grandchild and max out the $75,000 gift limit for each. This allows for possible (tax free) growth on $750,000 outside of the grandparent's estate. However, if one of the beneficiaries decided not to continue post-secondary education and the grandparent seeks to change the beneficiary, the possibility of triggering a "generation skipping tax" needs to be considered.

The mechanics of the "front loading" of gifts to a 529 plan can get complicated if the grandparent or grantee passes away. For example, if a grandparent gives the full $75,000 to a grandchild and passes away three years later, the first three years fall under the gift exemption, but the remaining amount in years four and five are added back into the grandparent's estate. There still remains a tax benefit as the growth of those funds occurs outside the estate.

TAXES, ADDITIONAL TAX CREDITS, EXEMPTIONS, AND DEDUCTIONS

The tax deductibility of 529 plans differ by state. Some states allow a deduction only for contributions to the in-state plan. Others will allow a deduction for contributions to any plan. Some states offer no state tax benefit. For all 529 plans, gains on investments in the plan are tax free when withdrawn and used for qualified education expenses. Funds withdrawn from 529 plans and not used for qualified expenses can face taxes on gains, penalties, and in some states, recapture of any tax deductions taken.

In addition to 529s, there may also be tax credits for families paying for education:

- The American Opportunity Tax Credit is available for 4 years of post-secondary education. It is a credit of $2,500 (100% on the first $2,000 of qualified expenses, and 25% on the next $2,000). If the credit brings the tax owed down to zero, a family can get a refund of up to $1,000 of the remaining credit. However, there is a phase-out for families with (modified) adjusted gross income of $160,000 to $180,000, and those earning more than $180,000 are not eligible. In addition, actual education expenses must be paid by the family; a student with a full scholarship, or one that has all of the expenses reimbursed by a 529 cannot take advantage of this credit.
- The Lifetime Learning Credit is a credit of 20% of qualified education expenses up to $10,000 per year for the taxpayer, the spouse or a child. This is only available for individuals with individual income below $68,000/$136,000 for a couple (with a phase-out starting at $58,000/$116,000), and needs to be thoughtfully coordinated with the American Opportunity Tax Credit. Each beneficiary is allowed to take one credit or the other, but not both.

Most wealthy investors assume they are not eligible for certain education-related tax credits or deductions. However, that may not be the case based on individual circumstances. A first step is to consider the tax situation of each family member as well as that of any potential contributors.

Adjusted Gross Income (AGI), taxable income, and the state of residence will impact the credits, exemptions, and deductions available when paying for education. While a parent may not be eligible for an education tax credit due to the parent's AGI, his or her child might be able to take the credit. For example, one of our clients has a daughter who had recently graduated and was working full time and completing her first tax return. Because the client's daughter was providing her own support, she realized she was eligible for the American Opportunity Tax Credit for tuition paid in her final semester of college. By integrating the daughter's situation with that of the parent, the family saved $2,500 in taxes. It is important to note that these education expenses, if used to claim a tax credit, cannot be reimbursed through 529 funds.

Additionally, for those in a position to affect final AGI, families might find it advantageous to do so. Pay particular attention to AGI for families facing variable income. Focus on lowering AGI through strategies such as 401(k) contributions.

USE OF FUNDS FOR EDUCATION

It is important to know the rules on what types of expenses are eligible under 529 plans and when those funds are available for withdrawal to avoid penalty. Using funds for anything other than qualified education expenses can cause tax, penalty, and a recapture of the state tax deduction. Tuition, room and board are the obvious eligible expenses. A full list of qualified education expenses can be found at https://www.irs.gov/pub/irs-pdf/p970.pdf.[2] Note that different expenses are considered qualified for 529 use and eligibility for the various tax credits. Also, some states might have definitions slightly different than the Federal definitions.

Withdrawals must only be taken from the account for the beneficiary who incurred the education expense. Taking from another's account, say a sibling, will subject the funds to the above-mentioned penalty and taxes. One other thing to keep in mind should a grandparent set up the 529 account is that funds in a 529 account are owned by the account owner; a beneficiary cannot call up and take funds out of the account. Distributions generally happen in three ways – the money can be paid to the educational institution, paid directly to the beneficiary, or paid to the account owner. While there are arguments on all sides about how best to distribute funds, in our experience grandparents enjoy giving and often like to have the funds distributed to themselves or directly to the beneficiary, rather than to the institution. Keeping good records and reminding grandchildren about what constitutes eligible expenses will be important.

Many education expenses for different types of higher education institutions are eligible; however, some are subject to limits. For example, someone living in off-campus housing might still be able to use 529 funds for some of the expenses, but these costs are limited to the housing expenses delineated by the college's financial aid department.

Both the timing and the amount of withdrawals are important as they can impact financial aid and education credit eligibility. Generally, withdrawals should be taken in the same calendar year as the expense occurred.

CHANGING BENEFICIARIES

When there are unused funds in a 529 account after the beneficiary has completed college, one sound strategy is to change the beneficiary and/or account owner. For example, the new beneficiary could be a younger sibling who has yet to complete college, or an older sibling with remaining graduate school expenses. A theoretical example of a new account owner could be an adult child assuming ownership to jump start the education funding for a current or future grandchild. It is important to be aware that a change of beneficiary or owner can be considered a gift for gift tax purposes. Advisors and accountants should ensure the process is handled correctly.

Money can remain in a 529 account even after the beneficiary completes college with no consequences. In fact, it can be a smart move to keep the funds in the account should the beneficiary later decide to return to school. If the money is likely to stay in the account for a while, it may make sense to reconsider the risk profile for the funds.

CONCLUSION

Thoughtful education planning can incorporate a combination of strategies, such as those mentioned here, and can ultimately establish education funding for multiple generations within a family. Successful strategies can also provide gifting and estate planning opportunities for parents and grandparents. Working with both your financial advisor, attorney, and accountant is the best way to structure a successful education planning strategy that works best given your personal financial situation.

Footnotes

1 https://research.collegeboard.org/pdf/trends-college-pricing-2019-full-report.pdf

2 https://www.irs.gov/credits-deductions/individuals/qualified-ed-expenses

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