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Education Investing Idea: Tax Advantaged Gift to Grandchild or Children: 529 Plan American Opportunity Credit Thanks to the Fiscal Cliff Deal & Lifetime Learning Tax Credit

529 Savings Plans Tax Advantaged for Child or Grandchild

529 Savings Plans work much like a 401K or IRA by investing your contributions. Your account will go up or down in value based on the performance of the particular options you select. Earnings are tax-free if used for qualified educational expenses.

Arizona is one of 5 states that provide a tax deduction regardless of what State's fund is used (up to $750 single or $1500 joint return). The Arizona deduction was made permanent in 2012. We recommend which state plan to use based on your objectives and our comparable analysis.

For example we often recommend plans that have a wide variety of growth objective options in addition to "Target" funds. Because "target" funds include bond allocations, they may not be timely currently, but could be switched into in the future (limited to one investment change per year).

The minimum initial purchase often is as low as $250 with $50 additions which can be set up monthly.

For 2013, the maximum contribution to avoid using part of each person's $5.2 million gift/estate/generation-skipping transfer tax exclusion, is $14,000 per person (or $28,000 per married couple). There is a special election available to combine up to 5 years' worth of contributions into one contribution of up to $70,000 per person or $140,000 per married couple.

There is a total value cap of $350,000 which if reached, disallows future contributions.

Unlike an UTMA you do not give up control, can even take back contributions

Some grandparents are being advised to gift away assets up to the exclusion amount to younger family members, as a way to reduce exposure to the estate tax. If you do not use the annual exclusion opportunity, you lose it. However, like many people who have worked hard to build up their net worth and who are uncertain about what the future may hold, you may be reluctant to do gifting because you do not wish to irrevocably part with your assets. With an UTMA account the child gets full control at age 21 in Arizona.

The "excuse" not to utilize your annual gift exclusion disappears with a 529 plan. You do not have to give up control. You can ask for the money back if you change your mind later on. The amount of the original contribution can be withdrawn without Federal tax or penalty, and would again just become part of your estate.

Qualified Costs

Eligible institutions include private colleges, public universities, community colleges, graduate schools, and trade schools. If the child or grandchild does not attend an eligible institution, you can change the beneficiary to another member of the family. You could even move the beneficiary up or down the family tree, naming the beneficiary's child, parent, or even yourself as replacement beneficiary.

Qualified Higher Educations Costs (QHEE) includes tuition, fees, books, supplies, equipment, and the additional expenses of a "special needs" beneficiary. It can include a limited amount of room and board.

Successor Owners Avoids Probate

I recommend you designate a successor which would avoid probate if the owner died before all of the money was withdrawn. A successor owner has even the right to request a refund of the original owner's contributions.

Financial Aid Considerations

A 529 account owned by a parent for a dependent student is reported on the federal financial aid application (FAFSA) as a parental asset, but is not included at all if owned by a grandparent in determining the student's Expected Family Contribution. If the 529 is owned by the parent, it is still a financial aid benefit since the parental rate of 5.64% is considerably less prejudicial than the 20% rate on non-529 assets owned by the student such as when he or she turns age 21 (in AZ) with a UTMA account as owner.

Along with favorable asset treatment, a 529 account also garners favorable treatment in the income portion of the financial aid eligibility formula. A tax-free distribution from a 529 plan to pay this year's college expenses will not be part of the "base-year income" that reduces next year's financial aid eligibility.

You Can Get $10,000 per Child in College Tax Credits, Thanks To the 2013 Fiscal Cliff Deal

The American Opportunity Credit has been extended to tax years 2013-2017 for parents of college students.

The credit reduces your federal tax bill dollar-for-dollar by up to $2,500 per year for each eligible college student for whom you pay qualified tuition expenses. It can be claimed on behalf of an undergraduate for four years—that's a $10,000 tax subsidy, over four years. And if you have more than one child in college at the same time, you can claim more than one credit.

This credit allows the inclusion of course materials and some computers. According to the IRS, "expenditure for a computer would qualify for the credit if the computer is needed as a condition of enrollment or attendance at the educational institution."

The American Opportunity Tax Credit may be worth more than the older Hope Scholarship and Lifetime Learning Credits. It also might be more valuable than the tuition and fees deduction which was extended only for 2013. But understandably, having all of those credits creates a lot of confused taxpayers and leads some to miss out.

As Ronald Reagan said, "The nine most terrifying words in the English language are, `I'm from the government and I'm here to help." A tax credit for paying college tuition expenses is a big help to families, but in trying to help the government has made claiming the credit confusing. According to the IRS, a lot of people are still confused: 3.1 million families claimed college tax credits improperly in 2010.

As with most all our tax laws it gets very complicated with a phase-out for incomes above $160,000 (joint modified adjusted gross) but can be a refundable credit for low-income families. Further, if you take distributions from a 529 Plan this can reduce the credit.

Lifetime Learning Tax Credit

While the American Opportunity Tax Credit provides up to $2,500 per student each year for up to four years of college, the Lifetime Learning Credit gives a maximum of $2,000 annually for education expenses without a limit on the number of years it can be claimed, and includes postgraduate education. Taxpayers can only receive one or the other of these credits per year. The higher income phase-outs are slightly different. Both credits even have a provision that no student will be eligible for either program if they have a felony drug conviction in the year the credit is earned.

Uncertain Other Educational Support

The future of other federal education funding for 2013 is still up for debate, as members of Congress have until March 1 to pass new legislation that would prevent cuts to popular financial aid programs such as federal work-study and Federal Supplemental Educational Opportunity Grants. These were not spared in the fiscal cliff deal and they are up for reduction if we go into sequestration.

The fate of subsidized student loan interest rates also rests with Washington politicians, who last year put a temporary freeze on a pending doubling of interest rates for certain undergraduate loans. Instead of rising from 3.4 percent to 6.8 percent last July 1, the interest rate on subsidized Stafford loans was kept at 3.4 percent through June 30, 2013. If Congress doesn't take action beforehand, the rates will automatically double on July 1 of this year for new loans.

Conclusion

Regardless of the various confusing tax options, a 529 Plan makes sense for many parents and grandparents.

While this is intended to be a general overview, you should consult a qualified tax professional for more specific tax information.

We specialize in the selection and implementation of 529 Plans that we believe meet your financial objectives and risk tolerance.

I look forward to discussing the many benefits of a 529 plan - especially in Arizona - with you further.

Sources include Forbes 1/16/2013 and other sources