

# College Planning: Know the Rules for Education Funding

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By Amy E. Buttell

**As college tuition continues to skyrocket, it's becoming more important than ever to know how the various savings plans work. This handy reference outlines the latest rules on the most popular college savings programs, and how to use them to save money on your children's education.**

Aside from retirement, saving for a child's college education is one of the biggest expenses a family encounters. And with college savings vehicles multiplying all the time and tax laws changing, the landscape of college education funding rules can be downright bewildering.

In deciding how much to contribute to college savings accounts, when to contribute, and where to invest those contributions, you'll need to remain aware of all your options and their accompanying rules. Hence, this handy guide.

## **College savings plans**

The biggest college savings plans are the Qualified Tuition Programs (QTPs) or Section 529 plans, education savings accounts (ESAs) or Coverdell savings accounts, and the Education Savings Bond program.

As the cost of college continues to climb, these college savings vehicles keep gathering assets. The College Savings Plan Network reported that 529 saving plan assets grew by 9.1% to \$247.9 billion in 2014. Fiscal Cliff legislation enacted in 2013 permanently extended what were previous temporary enhancements to Coverdell savings accounts. Parents and grandparents can continue to contribute up to \$2,000 a year to a Coverdell account and use those funds for kindergarten through 12th grade expenses.

## College Savings Programs

|                                       | <b>Section 529 Plans<br/>(Qualified Tuition Programs)</b>                                    |   | <b>Coverdell<br/>Savings Accounts</b>  | <b>Education Savings<br/>Bond Program</b>  |
|---------------------------------------|--|---|--|--|
|                                       | 529 College Savings<br>Plans   | 529 Prepaid<br>Plans  |  | Series EE or Series I  |
| <b>Contribution limit</b>             | Amount necessary to pay for qualified educational expenses                                   | Amount necessary to pay for qualified educational expenses                                | \$2,000 a year per beneficiary   | \$10,000 face value per year per owner per type of bond  |
| <b>Who can contribute or purchase</b> | Anyone   | Anyone  | Anyone whose MAGI is less than \$110,000 single or \$220,000 joint for the year; also organizations, such as corporations and trusts (no income-related requirement) | Parent, spouse of student, or student; must be at least age 24 on bond issue date; married parents must file jointly   |
| <b>Account ownership</b>              | Parent or guardian   | Parent or guardian  | “Responsible individual” (generally the parent or guardian)  | If purchased by parents, must be registered in parents’ names (child cannot be listed as co-owner)   |
| <b>Tax deductibility</b>              | Not on federal level; state deduction depends on plan  | Not on federal level; state deduction depends on plan                                     | No federal or state tax deduction  | Income exempt from state and local taxes; federal exemption phases out at MAGI of \$92,500 single, \$146,300 joint   |
| <b>Beneficiary change</b>             | Can be changed to any relative of initial beneficiary  | Can be changed to relative of initial beneficiary   | Can be changed to relative of initial beneficiary  | Can be changed to another beneficiary  |
| <b>Financial aid treatment</b>        | Asset of parent  | Asset of parent   | Asset of account holder; low impact on dependent student owners  | Asset of bond owner  |
| <b>Contribution income limits</b>     | None, although states set limits on total contributions ranging from \$200,000 on up         | None, although often limited to current cost of 4-year degree program                     | Contribution limit reduced for MAGI between \$95,000-\$110,000 single, \$190,000-\$220,000 joint   | Income phaseouts based on year redeemed—not purchased. Contribution limit begins to phase out for MAGI of \$77,500 single and head of household, \$116,300 joint |
| <b>Rollover eligibility</b>           | Can be rolled over to another 529 plan without penalty once every 12 months                  | Can be rolled over to another 529 plan without penalty once every 12 months               | Can be rolled over to a 529 plan or another Coverdell for same beneficiary or another in beneficiary’s family who is under age 30                                    | Can redeem and roll proceeds over to 529 plan  |
| <b>Distributions/ Interest</b>        | Not taxed if used for qualified purpose; non-qualified subject to income tax and 10% penalty | Not taxed if used for qualified purpose; non-qualified subject to income tax, 10% penalty | Not taxed if used for qualified purpose; non-qualified subject to income tax and 10% penalty; distributions must be taken by the time beneficiary reaches age 30     | Interest exempt from state and local taxes; no federal tax if used for qualified purpose and MAGI is below \$92,500 single, \$146,300 joint                      |

Sources: “IRS Publication 970; “Tax Benefits for Education,” IRS; FinAid; SavingforCollege.com; Sallie Mae

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# Student loan availability and limits

For many children of high-net-worth families, much of a financial aid package from colleges comes in the form of student loans. These loans take a variety of forms and have limits on how much a student or parent can borrow, the interest rates charged, and repayment terms.

An important distinction with student loans is whether they are “subsidized” or not. Interest on unsubsidized loans starts accruing when the loan is disbursed, although no payments are required while the student is enrolled in school at least half time (unpaid interest is capitalized at the end of the grace period). Interest on

| Student Loan Options                                  |   |  |   |   |   |
|---|---|--|---|---|---|
| Loan Type   | Source  | Limits   |   | Interest rates<br>(2015–16 school year)   | Repayment   |
| <b>Undergraduate Stafford, dependent students</b>     | Federal government                                      | 1st year   | \$5,500 (\$3,500 subsidized, \$2,000 unsubsidized)                        | 4.29% subsidized; 4.29% unsubsidized, plus 1.068% loan fee  | 6 months following graduation or if enrollment drops below half time  |
|   |   | 2nd year   | \$6,500 (\$4,500 subsidized, \$2,000 unsubsidized)                        |   |   |
|   |   | 3rd & 4th year   | \$7,500 (\$5,500 subsidized, \$2,000 unsubsidized)                        |   |   |
|   |   | Lifetime limit   | \$31,000 (up to \$23,000 subsidized)                                      |   |   |
| <b>Undergraduate Stafford, independent students</b>   | Federal government                                      | 1st year   | \$9,500 (\$3,500 subsidized, \$6,000 unsubsidized)                        | 4.29%, subsidized; 4.29% unsubsidized, plus 1.068% loan fee   | 6 months following graduation or if enrollment drops below half time  |
|   |   | 2nd year   | \$10,500 (\$4,500 subsidized, \$6,000 unsubsidized)                       |   |   |
|   |   | 3rd & 4th year   | \$12,500 (\$5,500 subsidized, \$7,000 unsubsidized)                       |   |   |
|   |   | Lifetime limit   | \$57,500 (up to \$23,000 subsidized)                                      |   |   |
| <b>Graduate Stafford, subsidized and unsubsidized</b> | Federal government                                      | Graduate   | \$20,500 per year (unsubsidized only)                                     | 5.84%   | 6 months following graduation or if enrollment drops below half time  |
|   |   | Lifetime limit   | \$138,500 (up to \$65,500 subsidized) or \$224,000 (health professionals) |   |   |
| <b>Perkins loans</b>                                  | Federal government                                      | Undergrad limit per year                               | \$5,500   | 5%  | 9 months following graduation or if enrollment drops below half time; repayment assistance available in exchange for service (i.e., certain teaching positions, military, etc.) |
|   |   | Grad limit per year                                    | \$8,000   |   |   |
|   |   | Undergrad limit  | \$27,500  |   |   |
|   |   | Combined undergrad and grad limit                      | \$60,000  |   |   |
| <b>PLUS loans for parents and grad students</b>       | Federal government                                      | Student’s cost of attendance minus other financial aid |   | 6.84% plus 4.272% loan origination fee  | Can make payments during school or defer to graduation; interest accrues on disbursement  |
| <b>Private or alternative loans</b>                   | Financial services companies incl. banks, credit unions | Student’s cost of attendance                           |   | Variable rates (Prime or Libor plus or minus a margin) depending on credit score, origination, and other fees | Immediate or deferred, depending on lender and terms  |

subsidized loans does not accrue while the student is enrolled at least half time.

Monthly interest that accrues on a student loan can be calculated with a daily interest formula. Current loan balance x number of days since last payment x interest rate factor, which you determine by dividing the loan's interest rate by the number of days in the year.

For example, an undergraduate student has a \$5,500 Stafford subsidized loan balance at a 4.29% interest rate and now plans to make his third payment. He calculates  $\$5,500 \times 25$  (days since last payment)  $\times 0.00011745$  (interest rate factor) = \$16.15 (interest owed since last payment).

Unlike undergraduates, graduate students are not eligible for new subsidized loans after July 1, 2012. But they may continue to use the subsidized loans they received prior to this date. The graduate student's \$65,500 cumulative subsidized loan limit takes into account pre-2012 subsidized loans for graduate and undergraduate coursework.

With subsidized and unsubsidized loans, payments must start six months after graduation (nine months for Perkins loans) or after dropping to less than half-time status.

In 2013, Congress agreed to market-based rates for loans. Student loans are now tied to the 10-year treasury note which means interest rates are likely to increase.

## Education tax credits

Fiscal cliff legislation extended the American Opportunity Tax Credit through December 31, 2017. Eligible taxpayers can claim only one of these credits in a given tax year for a single student. However, if a taxpayer claims two eligible students on a return, one credit can be claimed for each student.

Credits can be selected on a per-student, per-year basis, which means taxpayers can switch between the American Opportunity Credit and the Lifetime Learning Credit for their children in different tax years, if they desire to do so. The HOPE Credit still exists, but only applies to 2008 and earlier tax years.

## Education Tax Credits

|                                 | American Opportunity Credit  |   |  | Lifetime Learning Credit   |   |  |
|---------------------------------|--|---|--|--|---|--|
| <b>Income limits</b>            | Single & HOH   | Credit phases out with MAGI between \$80,000 and \$90,000   | Credit can't be claimed with MAGI of \$90,000 or more  | Single & HOH   | Credit phases out with MAGI between \$55,000 and \$65,000   | Credit can't be claimed with MAGI of \$65,000 or more  |
|                                 | Joint  | Credit phases out with MAGI between \$160,000 and \$180,000 | Credit can't be claimed with MAGI of \$180,000 or more | Joint  | Credit phases out with MAGI between \$111,000 and \$130,000 | Credit can't be claimed with MAGI of \$130,000 or more |
| <b>Applies to</b>               | Students pursuing a degree or federally recognized educational credential; must be enrolled at least half time; can't also claim Lifetime Learning credit for same student |   |  | Students enrolled in postsecondary education classes or those to acquire or improve job skills |   |  |
| <b>Qualified expenses</b>       | Tuition, fees, course materials  |   |  | Tuition, fees, supplies, and equipment   |   |  |
| <b>Availability</b>             | Only for first 4 years of postsecondary education for this and the Hope Credit   |   |  | No limit   |   |  |
| <b>Maximum amount of credit</b> | 100% of first \$2,000 plus 25% of next \$2,000 for maximum credit of \$2,500 per eligible student per year; 40% of credit is refundable (up to \$1,000)                    |   |  | 20% of qualified expenses up to \$10,000 for maximum \$2,000 credit per tax return             |   |  |
| <b>Filing status</b>            | Ineligible if married filing separately  |   |  | Ineligible if married filing separately  |   |  |

Sources: "IRS Publication 970; "Tax Benefits for Education," IRS; FinAid; SavingforCollege.com; Sallie Mae

## Student loan interest deduction

Eligible taxpayers are permitted to deduct a certain amount of student loan interest. You may take this deduction if the interest is eligible—that is, from a qualified educational institution and the purpose was education—and if your modified adjusted gross income is less than \$80,000 (phaseout between \$65,000 and \$80,000) for a single taxpayer and \$160,000 (phaseout between \$130,000 and \$160,000) for married filing jointly.

The maximum deduction is \$2,500 and claimed directly from gross income. The student must be the taxpayer, the taxpayer's spouse, or a dependent enrolled at least half time in a degree program. Qualified educational expenses include tuition, room and board, books, supplies, equipment, and other necessary expenses.

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