By Laura E. Hoexter

We want to start saving for our child's education. What is the best way to do this?

There are many ways to save for and fund your child's education—whether through the use of a 529 plan account, a Coverdell Education Savings Account, an Irrevocable Education Trust, Education Credits or an Education Savings Bonds. The best plan for you will depend on your personal goals and your financial and tax situation.

529 PLANS

What is a 529 plan?

Many states and certain private universities have established programs to allow people to save for their future educational needs or the future educational needs of another. These savings programs qualify for tax incentives under Section 529 of the Internal Revenue Code of 1986 and thus are also known as "529 plans."

Is each state's 529 plan the same?

There are two main types of 529 plans: (1) prepaid tuition plans, and (2) savings account plans. A prepaid tuition plan is generally a plan which allows a person (called the Account Owner) to establish an account, transfer funds into this account, and buy tuition credits at today's rate to be used in the future. By prepaying the beneficiary's education, the Account Owner is betting that the tuition rates will increase faster than the average market return. The cost of the tuition credits is usually indexed against a chosen institution. For instance, Washington state has a prepaid tuition plan which is indexed to the most expensive university in the state – usually either the University of Washington or Washington State University.

The other type of 529 plan is a savings account plan. Under this plan, an Account Owner establishes an account and contributes cash, which is then invested in selected investment bundles. By choosing to use a savings account, the Account Owner is betting that the market will outperform the rising cost of tuition. New Hampshire is one of many states with a typical savings account plan.

Who can open a 529 plan account?

Any individual can open a 529 account. However, a few states have residency restrictions, which require either the Account Owner or the Beneficiary to live in the state. If you are interested in participating in an out-of-state plan, be sure to look into any residency requirements beforehand. Under certain state plans, corporations, partnerships, non-profit organizations, custodians, trusts, and other entities are permitted to open 529 accounts. Generally, only one individual/entity is permitted to be an Account Owner. Therefore, many plans require married couples to designate either the husband or wife as the Account Owner. In these situations, you want to be sure to designate a contingent owner in the event that something happens to both the husband and wife.

Who can be the beneficiary of an account?

The beneficiary of an account must be a specified individual, but there is no requirement that the beneficiary be related to the Account Owner. Many states even allow an Account Owner to establish an account on his or her own behalf.

Who can contribute to a 529 plan account?

Any person can contribute to a 529 plan account, not just the Account Owner. This means that if a father establishes an account for his child, the grandparents may contribute to such account. However, only the Account Owner can make a distribution to the beneficiary, change the beneficiary, or take a refund of the account funds. Therefore, in order to maintain control over the account balance, many people choose to establish their own account rather than contribute to an existing account. Contributions to an account may be made only in cash—not stocks, bonds or real estate. However, payment may be made by cash, check, money order, credit card or similar methods.

Are contributions to a 529 plan account deductible against income tax?

Contributions to a 529 plan account are not deductible against federal income tax, although certain states may allow a deduction against state income tax if you participate in that state's plan.

Are contributions to a 529 plan account subject to other taxes?

Contributions to these accounts are eligible for the annual gift tax exclusion under 2503(b) and the generation-skipping transfer tax exclusion under 2642(c). A donor may elect to take certain contributions to a 529 plan into account ratably over a five-year period in determining the amount of gifts made during the calendar year. The election is made on Form 709, Federal Gift Tax Return. If after the first year of the five-year period the annual exclusion amount is increased, the donor may make an additional contribution in any one or more of the four remaining years up to the difference between the exclusion amount as increased and the original exclusion amount for the year or years in which the original contribution was made. If the donor makes a taxable gift, the taxable portion of the gift may not be accounted for ratably and such excess is treated as a taxable gift in the calendar year of the contribution.

For example, P set up a plan in 2011 for his child, C. P can give $13,000 to the plan tax-free in 2011 using his full annual exclusion. Alternatively, P can give up to $65,000 to the plan and elect to treat this contribution as a gift of $13,000 over the five-year period beginning in 2011. He would make this election on his Gift Tax, IRS Form 709. Now, let's change the facts. Instead of gifting $65,000, suppose P only gifted $30,000 in 2011. He has two choices. He can treat this as a tax-free gift of $13,000 and report the additional $17,000 as a taxable gift, or he can elect to treat the $30,000 gift as having been made ratably over five years ($6,000 per year). P cannot treat this as a gift made over a period of less than five years. In any year P is deemed to have gifted less than the annual exclusion amount, he can make additional gifts.

Is there a limit on how much I can contribute to a plan?

Congress has placed safeguards on 529 plans to ensure that these accounts are used primarily for educational savings. One of these safeguards is a limit on the amount that a donor can contribute to a 529 plan. The Treasury Regulations offer a safe harbor for plans; a plan will qualify for favorable tax treatment if a donor's contributions to each beneficiary's account is limited to an amount, as determined by actuarial estimates, that is necessary to pay tuition, required fees, and room and board expenses of the beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program. Because the cost of tuition can vary between states, these maximums vary between plans. In addition, although some states have chosen to follow Congress's guideline in setting their contribution limits, some have chosen their own standard of measurement. Therefore, when choosing among 529 plans, the contribution limit should be considered.

Is there a minimum that I must contribute?

While the Treasury Regulations don't mandate a minimum contribution requirement, each state plan has a minimum balance necessary to open an account. If contributions are made through automatic payroll deduction or through monthly payments rather than a lump sum gift, additional minimums may apply.

If I open an account and later want to change ownership, may I?

Under most state plans, during an Account Owner's lifetime, an Account Owner can designate a Contingent Account Owner by completing the necessary forms provided by the Plan Manager. When transferring ownership of the account, there does not need to be a change of beneficiary. Generally, upon transfer of ownership, the entire account balance will be irrevocably assigned to the new Account Owner.

Can I change the beneficiary on one of my accounts?

An Account Owner can change the beneficiary of an account at any time. The change of beneficiary will not incur any gift tax or generation-skipping transfer tax as long as the new beneficiary is a "member of the old beneficiary's family" and the new beneficiary is the same generation as the old beneficiary.

A "member of the family" is any individual who is the beneficiary's (1) son, daughter or descendant of either, (2) stepson or stepdaughter, (3) brother, sister, stepbrother or stepsister (including half-blood), (4) father, mother or ancestor of either, (5) stepfather or stepmother, (6) son or daughter of a brother or sister, (7) brother or sister of the beneficiary's father or mother, (8) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary, (9) cousin, or (10) the spouse of the designated beneficiary or the spouse of any individual mentioned in (1) through (9). The inclusion of cousins allows grandparents to move accounts between grandchildren without penalty.

However, if the new beneficiary is in a different generation than the former beneficiary, regardless of the familial relationship, the transfer is subject to gift tax. If the new beneficiary is two or more generations lower than the former beneficiary, the transfer will also be subject to the generation-skipping transfer tax. In both cases, the old beneficiary is deemed the transferor, although Congress is currently reconsidering this.

To illustrate this point, suppose in Year 1, P makes a contribution to a 529 plan on behalf of his child, C. In Year 4, P directs that C's account be rolled into an account for the benefit of P's grandchild, G. There is no income tax consequence to the rollover, nor is there any penalty associated with the rollover. However, the rollover distribution is treated as a taxable gift by C to G, because G is a generation below C. However, because G is only one generation below C, there is no generation-skipping transfer tax liability.

The designation of a new beneficiary will be prohibited if the change would cause the aggregate balances of all accounts for the new beneficiary to exceed the maximum contribution limit for the new beneficiary.

Can I transfer funds from an account for my oldest child to an account for my youngest child?

An Account Owner can transfer all or a portion of his or her account balance to another account for a different beneficiary. The receiving account can either be owned by the Account Owner or by another Account Owner in the program. However, the beneficiary of the account receiving the funds must be a member of the family of the beneficiary from which account the funds are transferred for the transfer to be tax free. Additionally, if the transferred funds would cause the receiving account to exceed the maximum contribution limit, then the transfer would be prohibited.

Can I transfer from one state plan to another?

An Account Owner may transfer funds from one qualified 529 plan to another without tax consequence once every 12 months, provided that the transfer of funds is for the benefit of the same beneficiary or for a member of the beneficiary's family of the same generation.

How are my contributions invested?

Each 529 plan generally offers a choice of investment options. There is usually at least one investment option that is based on the beneficiary's age. This age-based asset allocation option generally offers a diversified investment portfolio of different mutual funds that invest in equities and fixed income instruments. Contributions are allocated among the mutual funds based on the age of the beneficiary in percentages that are weighted more heavily toward equities when the beneficiary is younger and toward bond and money market investments as the beneficiary approaches college age. There are usually other investment options available to the Account Owner, such as a 100% or 70% equity portfolio.

Can I select the investment options?

An Account Owner can allocate contributions among one or more of the investment options offered. Although the Account Owners may select the investment options for contributions, they cannot exercise investment discretion directly or indirectly over contributions to the account or its earnings. Additionally, once made, contributions and earnings may not be transferred to another investment option unless the Account Owner also changes the beneficiary of the account.

Will the 529 plan assets be taken into account for financial aid eligibility?

Being an Account Owner or a beneficiary of an account may impact a student's eligibility for financial aid. Generally, an account will be treated as an asset of the Account Owner, not as an asset of the beneficiary. Thus, for purposes of determining a student's eligibility for federal financial aid, an account will be treated like other investment assets of the Account Owner, such as savings accounts, mutual funds, stocks or bonds, which may or may not affect the student's eligibility for federal financial aid. In addition, if the earnings portion of a distribution is included in the taxable income of a beneficiary (i.e. if non-qualified distributions were made to the beneficiary), such distributions might affect a student's eligibility for financial aid in the subsequent year. Washington state, for state financial aid purposes, only considers income. All assets, including 529 plan account balances, are excluded from consideration. However, there are some schools that consider 529 account balances when determining a student's eligibility for financial aid. You should contact the financial aid department of a particular school if you are concerned.

Would I be able to borrow against the plan investments?

Generally, neither the Account Owner nor a beneficiary may assign, transfer or pledge the plan account as security for a loan. This includes financing the purchase of an interest in the program. There is one exception to this rule. An interest in a program or a portion of such interest may be used as security for a loan if the contract giving rise to the interest was entered into or the account was opened prior to August 20, 1996 and the state plan permitted such a pledge.

How is money withdrawn from the account?

There are four types of withdrawals and distributions from an account: (1) distributions for qualified higher education expenses, (2) rollover distributions, (3) nonqualified distributions, and (4) refunds. All distributions from a 529 plan to a beneficiary must be included in the gross income of the beneficiary to the extent of the earnings portion of the distribution. However, there are two exceptions to this rule: (1) distributions for qualified higher education expenses made after 2001, and (2) rollover distributions.

What is a distribution for "Qualified Higher Education Expense"?

Distributions for "Qualified Higher Education Expenses" include payments for tuition, fees, and the costs of books, supplies, and equipment required for the enrollment or attendance of a beneficiary at an eligible educational institution. Room and board is treated as a Qualified Higher Education Expense if the beneficiary is enrolled in a degree, certificate or other program that leads to a recognized educational credential awarded by an eligible institution. For a beneficiary residing at home, room and board costs are generally limited to the minimum room and board allowance permitted for federal financial aid programs. For a beneficiary residing in university-owned housing, room and board costs are generally limited to the costs assessed for room and board at the institution. Qualified Higher Education Expenses are entirely excluded from income tax.

What are rollover distributions?

An Account Owner can choose to roll the balance of one account into an account of another individual. If the recipient account is held for a person who is a "member of the family" of the initial beneficiary, then the rollover distribution is not subject to income tax. However, the rollover distribution may be subject to gift tax if the new beneficiary is not in the same generation as the initial beneficiary. Additionally, the rollover may be subject to generation-skipping tax if the new beneficiary is one generation or more removed from the initial beneficiary (a "skip beneficiary").

What are nonqualified distributions and refunds?

At any time, an Account Owner can distribute all or a portion of the account balance to the beneficiary for reasons other than qualified higher educational expenses (hereafter, "nonqualified distributions") or the Account Owner can request a refund of all or a portion of the account balance. Both nonqualified distributions and refunds must be included in the gross income of the beneficiary to the extent of the earnings portion of the distribution. Additionally, federal law imposes a 10% penalty on such nonqualified distributions and refunds, and some states may impose their own penalties.

If nonqualified distributions and refunds are made due to (1) the death or disability of the designated beneficiary, or (2) the beneficiary's receipt of a scholarship, neither income tax nor penalties are imposed on such distribution or refund.

What happens when the Account Owner dies?

If an Account Owner dies, the 529 account may not be included as an asset in the Account Owner's taxable estate. However, if an Account Owner made an election to account for contributions ratably over a five-year period and the Account Owner dies within the five-year period, that portion of the contribution allocable to calendar years beginning after the date of death of the Account Owner is includible in his or her gross estate. Most plans allow Account Owners to designate Contingent Account Owners in the event of their death. These Contingent Account owners will take over all rights to the account, including the right to claim a refund. In the event that no Contingent Account Owner is named, some plans provide that the ownership will pass to the beneficiary named under the Account Owner's last will and testament. Other plans provide that the account ownership will automatically pass to the account beneficiary. It is very important to review your individual plan to determine your ability to pass the ownership rights to your account at your death, and to bring a copy of your plan document to your estate planning attorney.

What happens if a beneficiary dies?

If a designated beneficiary dies, the entire account may be includible in the beneficiary's gross estate.

Does the 529 plan affect other education tax credits?

A 529 plan distribution may be made in the same year that you claim an American opportunity or lifetime learning credit as long as you are not claiming the credits for the same educational expenses for which the 529 distribution was made.

Can you tell me a little bit about Washington's 529 plan?

The State of Washington has established a prepaid tuition program called the Guaranteed Education Tuition or GET Program. The GET Program allows taxpayers to purchase college tuition units at today's prices and redeem them at a later date.

How the Program Works. The GET Program works on a unit system, with 100 units equaling a full year's tuition at the University of Washington. This means that if a taxpayer purchases 100 units, the State of Washington guarantees that when the taxpayer's named beneficiary enrolls in college, he or she will receive at least one full year's tuition at a Washington state university, college, or community/technical college, free of charge, regardless of the cost of tuition at that time.

To illustrate this, suppose Dad purchases 100 units for Son in 1990. In 1998, Son is accepted to the University of Washington and in that same year, Dad redeems the 100 units for Son to receive one year of tuition at the University of Washington. Had Son attended Washington State University, he could have redeemed the same 100 units to receive a full year's tuition at that university. However, had Son attended Central Washington University, Eastern Washington University, Western Washington University, or Evergreen State College, Son would only have to redeem 78 units to cover the cost of tuition at those schools. Similarly, had Son attended a community or technical college, he would only have to redeem 43 units to cover a full year's tuition. In those latter scenarios, because the value of the units are indexed against the state universities, Son could have redeemed the 100 units and used any excess units to pay for books, room and board.

Schools Eligible. A student beneficiary may attend any university, college, or trade school—whether public or private—in any state that qualifies for the receipt of federal financial aid. While the GET account keeps pace with any increases in Washington in-state public institutions, the beneficiary is not limited to attending an in-state school. If the beneficiary attends an out-of-state or private school, the units are redeemable and the beneficiary is given credit equal to the dollar value of the average weighted tuition unit for Washington four-year public colleges and universities. Because the units are measured against Washington institutions, there is no guarantee that 100 units will cover the full cost of an out-of-state school.

Suppose in the example above, Son had chosen to attend Harvard rather than the University of Washington. Assuming Harvard's tuition exceeds the weighted average of a four-year institution in Washington state, Son could still redeem the 100 units. The State of Washington would pay Harvard an amount equal to the cost of a full year's tuition at the University of Washington. Son would be responsible for paying the difference between Harvard's and the University of Washington's tuition rates.

Who Can Open an Account. Anyone can open an account for the benefit of himself/herself or another. The purchaser can be an organization such as a corporation, trust, non-profit organization, foundation, or partnership. There may only be one owner per account. In Washington, a community property state, this may raise some unintended consequences. If you are a married couple and have a GET account, you should consult your attorney regarding the estate planning ramifications.

Who Can Be the Beneficiary. If the Account Owner is not a Washington resident, the beneficiary must be a Washington resident at the time the account is opened. After that, the beneficiary may move anywhere without losing benefits.

Maximum Contribution. Currently, a beneficiary may only have 500 units purchased on his or her behalf. Therefore, if grandparents purchase 200 units for grandson, parents may open an account for their son but are limited to purchasing only 300 units.

Investments: Price and Purchase Options. GET units can be purchased two ways: by a lump sum purchase or through a customized monthly payment plan. Under the lump sum purchase arrangement, an individual can purchase as little as one unit or as many as 500 units at the current year's unit price.

The current price of a unit (through the March 31, 2011 enrollment period) is $117. This price is adjusted in May and September of each year. Alternatively, an individual can purchase units through a customized purchase plan. This payment method allows an individual to purchase an agreed number of units on an installment basis with monthly contributions over a specified number of years (with a maximum of 10 years). If the units are purchased through a monthly payment plan, the price is not recalculated each year but is generally a bit higher than the lump sum unit price to reflect interest.

Distributions from the Account. At the Account Owner's direction, the plan will make (1) distributions for qualified higher educational expenses, (2) rollover distributions, (3) nonqualified distributions, and (4) refund distributions to the Account Owner. Each of these carries its own tax consequences. The GET program, however, imposes additional restrictions. First, the account must be open for at least two years prior to redeeming any of the units. Second, the Account Owner can only request a refund of one year's tuition per year.

Death of an Account Owner. The original Account Owner may transfer ownership rights under the GET plan to another person. If the Account Owner dies, becomes legally incompetent or cannot be located by the program and the Account Owner has not designated another person to assume control of the plan, the ownership rights and responsibilities will vest in the beneficiary (or in the beneficiary's guardian if the beneficiary is a minor).

History of Tuition Increases in Washington. From 2001-2011, resident tuition and state mandated frees at Washington's public universities have increased an average of 8.9%. The tuition increase for the 2010-2011 year is expected to be 13%.

COVERDELL EDUCATION SAVINGS ACCOUNTS

What are Coverdell Education Savings Accounts (formerly called Education IRAs)?

A Coverdell ESA is a trust which meets statutory requirements and is created exclusively for the purpose of paying qualified education expenses of a designated beneficiary. The Trustee of the trust must be a bank or other person or entity qualified to administer Individual Retirement Accounts.

Who can open a Coverdell ESA?

In 2010, if your modified adjusted gross income is less than $110,000 ($220,000 if you are filing a joint return), then you can open a Coverdell ESA. Corporations, tax-exempt organizations, or other entities may make contributions to a Coverdell ESA regardless of the entity's income, subject to the dollar contribution limit per beneficiary.

Who can be the beneficiary of a Coverdell ESA?

A Coverdell ESA can only be established for a person under eighteen years of age or a special needs beneficiary.

Are there restrictions on contributions?

Contributions to Coverdell ESAs must be made in cash. While there is no limit on the number of Coverdell ESAs that can be established for the benefit of a child, the aggregate contributions for the child cannot exceed $2,000 per year.

How are contributions taxed?

Contributions to Coverdell ESAs are non-deductible for income tax purposes. Such contributions are eligible for the annual gift tax exclusion under 2503(b) and the generation-skipping transfer tax exclusion under 2642(c)(2).

When must a contribution be made?

While contributions to 529 plans must be made by the end of the calendar year, contributions to Coverdell ESAs can be made by April 15 and still be considered a gift for the prior year. No contributions may be made after a beneficiary turns 18.

Are there investment limitations?

A Coverdell ESA is generally invested like any other IRA. However, ESA assets cannot be invested in life insurance contracts, nor can ESA assets be commingled with other assets except in a common trust fund or common investment fund.

Do Coverdell ESAs impact qualification for financial aid?

Coverdell ESAs may be taken into account in determining qualification for financial aid. Therefore, families will have to weigh the tax advantages of a Coverdell ESA against the decreased ability to qualify for financial aid. For certain families it may make sense to save for college outside of these tax-saving vehicles in order to preserve eligibility for financial aid. Families with income too high to qualify for financial aid, yet low enough to participate in a Coverdell ESA, should consider these vehicles.

How are distributions from a Coverdell ESA made?

There are three types of distributions from a Coverdell ESA: (1) distributions for Qualified Educational Expenses, (2) rollover distributions, and (3) nonqualified distributions. Unlike 529 plans, there is no ability for a donor to request a refund of unused amounts. Each of the foregoing distributions carries its own tax consequences.

What are distributions for "Qualified Education Expenses"?

For purposes of a Coverdell ESA, the term Qualified Education Expenses is defined the same as Qualified Higher Education Expenses for 529 plans plus it includes tuition, fees, academic tutoring, books, supplies, and other equipment which are incurred in connection with the enrollment or attendance at a public, private, or religious elementary or secondary school (kindergarten through grade 12). Additionally, it includes expenses for room and board, uniforms, transportation, and supplementary items and services (including extended day programs) which are required or provided by a public, private, or religious school in connection with enrollment or attendance. Finally, it includes expenses for the purchase of any computer technology, equipment, or internet access, and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. However, it does not include expenses for computer software designed for sports, games or hobbies unless the software is predominantly educational in nature. Distributions for Qualified Education Expenses from a Coverdell ESA are excluded from gross income of the beneficiary.

What are rollover distributions?

Rollover distributions are distributions from one account held for the benefit of a beneficiary to another account held for the benefit of a different beneficiary. Any amounts not withdrawn by one beneficiary may be rolled over within 60 days to a Coverdell ESA for any "member of the beneficiary's family" with no income tax consequences, provided the new beneficiary is under 30 years of age.

A "member of the family" is defined the same as under 529 plans. It includes any individual who is the beneficiary's (1) son, daughter or descendant of either, (2) stepson or stepdaughter, (3) brother, sister, stepbrother or stepsister (including halfblood), (4) father, mother, or ancestor of either, (5) stepfather or stepmother, (6) son or daughter of a brother or sister, (7) brother or sister of the beneficiary's father or mother, (8) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary, (9) cousin, or (10) the spouse of the designated beneficiary or the spouse of any individual mentioned in (1) through (9).

A beneficiary may waive tax-free treatment of distributions from a Coverdell ESA and elect to pay any tax that would otherwise be owed on the distribution to be eligible to claim a American opportunity or lifetime learning credit for qualified higher education expenses paid in that tax year. The 10% penalty usually imposed on nonqualified taxable distributions will not be imposed.

While there may be no income tax consequences associated with a rollover to an account for a family member, there may be gift tax consequences, and if the new beneficiary is in a "skip generation," there may be generation-skipping tax consequences.

What are non-qualified distributions?

Distributions for expenses other than Qualified Education Expenses and rollovers are considered nonqualified distributions. The portion of a nonqualified distribution that represents earnings will be subject to income tax and, in addition, such distribution will be subject to a 10% penalty similar to the penalties on nonqualified distributions from 529 plans.

When must the ESA terminate?

Assets remaining in an ESA must be distributed to the beneficiary (or the beneficiary's estate) 30 days after (1) the beneficiary attains 30 years of age (unless the beneficiary is a special needs beneficiary), or (2) the beneficiary's death, whichever is earlier.

What happens to the remaining funds when the ESA terminates?

The earnings accumulated tax-free in the account must be included in the beneficiary's taxable income. However, such earnings are excluded from the beneficiary's income if the distribution is (1) made due to the death of the beneficiary, (2) made due to the disability of the beneficiary, (3) made because the beneficiary was awarded a scholarship (to the extent the distribution is not more than the scholarship amount), or (4) an amount which is includible in gross income solely because the taxpayer elected to waive the tax benefit for the year.

What happens if a donor dies?

No amount of an ESA will be included in the gross estate of any individual because such an individual contributed to an ESA.

How does the Coverdell ESA affect other tax credits?

Taxpayers can contribute to an ESA and a 529 program for the same beneficiary in the same year. Additionally, taxpayers can also claim an American opportunity or lifetime learning credit in the same year as a distribution from an ESA. However, a beneficiary cannot use the credit and receive a distribution for the same expense.

IRREVOCABLE EDUCATION TRUST

What is an Irrevocable Education Trust?

An Irrevocable Education Trust is simply a trust established by any individual (the "Grantor") in conjunction with his or her attorney. The Grantor designates the beneficiary or beneficiaries of the trust in the trust agreement. The Grantor also names a Trustee. This is the person or institution who will hold, administer and distribute the trust assets. If an individual is named as Trustee, such individual is always permitted to work with an institution, broker or any advisor desirable. Finally, the Grantor designates guidelines for distributions. With a trust, the Grantor is free to define the limitation on distributions as he or she desires. For instance, the Grantor can be very inclusive and permit distributions for all education levels, including elementary, middle school, junior high, high school, undergraduate, graduate, post-graduate, as well as any technical or vocational training, or the Grantor can be more restrictive and permit distributions only for a particular level such as undergraduate education. The Grantor can provide the Trustee with broad authority to distribute funds for tuition, lab fees, books, supplies as well as room and board, computer equipment and supplies, uniforms, transportation, and travel and recreation of an educational nature, or the Grantor can restrict distributions, such as allowing distributions for tuition only. All of these decisions must be made by the Grantor at the time the trust is established.

Who can establish a trust?

Any individual can establish an Irrevocable Education Trust. In addition, a couple can jointly establish such a trust.

Who can be the beneficiary?

Any individual or individuals, regardless of age, can be the beneficiaries of the trust. To achieve the most optimal tax benefits, the Grantor should not name himself or herself as a beneficiary.

How do I make contributions?

Contributions can be made to the trust by the Grantor, or any other individual except a beneficiary. There is no minimum or maximum contribution limits on amounts transferred.

How are contributions taxed?

Contributions to the trust are non-deductible for income tax purposes. With proper notice, such contributions may be eligible for the annual gift tax exclusion under 2503(b).

Can I change the terms of the trust or the beneficiary?

The trust is irrevocable once signed by the Grantor. Therefore, it cannot be amended or revoked, once formed. Additionally, the beneficiaries cannot be changed once the trust is established. The Grantor, however, at the time the trust is established can give an independent party the power to make changes to the trust in the future. Once funds are transferred into the trust, the Grantor cannot direct that they be used for the benefit of another beneficiary, nor can the Grantor move funds from one trust to another.

How are investments managed?

Unlike 529 Plans and Coverdell ESAs, the Grantor can specify in the trust instrument how the funds should be invested. However, once signed, the Trustee is free to invest the funds as the Trustee deems most appropriate within the guidelines set forth by the Grantor. For example, suppose a Grantor establishes a trust for his son and the Grantor names his brother, John, as Trustee. In the trust agreement, the Grantor states that the Trustee cannot invest in the real estate market. John is free to make all investment decisions but must adhere to the terms of the trust agreement, and refrain from making any real estate investments with the trust funds.

What types of investments are permissible?

Unless specified in the trust instrument, there are no restrictions on the type of investments. However, by law the Trustee has a fiduciary duty to make the assets as productive as possible and to ensure that the portfolio is sufficiently diversified.

How is the trust's income taxed?

Unlike 529 plans and Coverdell ESAs, the Irrevocable Education Trust is not a tax-deferred vehicle. All income earned by the trust is taxable. If the trust does not make any distributions, all income from that year will be reportable by the Trustee. If the Trustee makes a distribution to a beneficiary, any income distributed to the beneficiary will be reportable by the beneficiary and any income retained by the Trustee will be reportable by the Trustee.

What effect does the trust have on eligibility for financial aid?

The trust is an independent taxpayer. A carefully drafted trust should not be deemed an asset of the parents in determining a student's eligibility. However, depending on how the trust is drafted and the educational institution involved, the trust may be considered an asset of the beneficiary.

How are trust distributions taxed?

Distributions are not taxable, except to the extent that they carry out taxable income. For example, suppose the trust earns $1,000 of income in 2009. In that same year, the Trustee distributes $800 to the beneficiary. The beneficiary pays income on the $800 and the Trustee pays the income tax liability on the remaining $200 of income. However, suppose the Trustee distributed $3,000 to the beneficiary. The beneficiary would only pay income tax on the income portion of the distribution ($1,000). The Trustee would pay no income tax.

Can I roll over any unused funds to another trust?

Once the trust is established, the Grantor cannot roll over the trust assets to another trust or to a person who is not a beneficiary of the trust. However, when establishing the trust the Grantor can name more than one beneficiary or he can set up a separate trust for each child and state in the trust document that at a certain age the Trustee should distribute the balance of the trust estate to the individual, or to the trust for the benefit of another child.

Can I, as the Grantor, get a refund of any funds not used for education?

To achieve the maximum tax benefit, no portion of the trust estate should revert back to the Grantor or the Grantor's spouse.

What happens if the Grantor dies?

Once the trust is established, the Grantor will have no rights or privileges over the trust assets. Therefore, no portion of the trust estate will be included in his or her gross estate for estate tax purposes.

What happens if a beneficiary dies?

At the beneficiary's death, no portion of the trust estate will be included in the beneficiary's gross estate. The trust will be held for or distributed to the person designated by Grantor in the trust instrument, free of estate tax.

How does the Irrevocable Education Trust interplay with other educational savings techniques?

While 529 plans and Coverdell ESAs allow tax-free savings for education, they have significant restrictions which may dissuade or prohibit a parent from participation. For instance, if a child is 14 years of age, a parent who qualifies and contributes the maximum allowable ($2,000/year) to an ESA may not be able to set aside sufficient funds for such child's education. Or, alternatively, a parent participating in a prepaid tuition 529 plan such as Washington's GET program may not have sufficient funds set aside if his or her child attends an out-of-state private school. An Irrevocable Education Trust can be used in place of a 529 plan or ESA, or can be used to supplement one or both techniques. Contributions to both can be made in the same year. Moreover, because non-cash gifts may be made to Irrevocable Education Trusts, but not 529 plan accounts or Coverdell ESAs, many parents with illiquid estates prefer to use Trusts as their education savings vehicle.

EDUCATION CREDITS

What are Education Credits?

There are two tax credits available to help taxpayers offset the costs of higher education by reducing the amount of your income tax: the American opportunity credit and the lifetime learning credit. The Hope credit is not available for 2010.

Each year you can elect only one of the credits for each student. For example, if you elect to take the American opportunity credit for a child on your 2010 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2010.

In addition, if you are eligible to claim both the American opportunity credit and the lifetime learning credit for the same student in the same year, you can choose to claim either credit, but not both.

Who is eligible for the American opportunity credit?

A taxpayer can claim the American opportunity credit if he or she paid qualified education expenses of higher education for an eligible student, where the eligible student is either the taxpayer, taxpayer's spouse, or a dependent of the taxpayer for whom the taxpayer claims an exemption on his or her tax return.

A taxpayer can claim an American opportunity credit only for an eligible student who meets all of the following requirements: (1) the student did not have expenses that were used to figure an American opportunity credit in any four earlier tax periods (this includes any years the Hope credit was claimed for the same student); (2) the student has not completed the first four years of post-secondary education before 2010; (3) the student is taking at least one-half of the normal full-time work load for the course of study for at least one academic period beginning in 2010; and (4) the student is free of any felony conviction for possessing or distributing a controlled substance.

How much is the American opportunity credit?

The amount of the American opportunity credit for each eligible student is the sum of: (1) 100% of the first $2,000 of qualified education expenses the taxpayer paid for the eligible student, and (2) 25% of the next $2,000 of qualified expenses the taxpayer paid for the eligible student. The maximum amount of American opportunity credit a taxpayer may claim in 2010 is $2,500 times the number of eligible students. A taxpayer can claim the full $2,500 for each eligible student for whom the taxpayer paid at least $4,000 of qualified education expenses.

For the purposes of the American opportunity credit, qualified education expenses include tuition and fees required for enrollment, as well as course-related books, supplies, and equipment.

Are there income limitations?

For 2010, the American opportunity credit is not available to individuals with modified adjusted gross income over $90,000 ($180,000 for married couples). The credit is reduced if the individual's gross income is between $80,000 and $90,000 ($160,000 and $180,000 for married couples). This credit is not available to married couples filing separately.

What is the lifetime learning credit?

An individual may be eligible for a lifetime learning credit of up to $2,000 for the total qualified education expenses paid for all students who are enrolled in eligible educational institutions.

Unlike the American opportunity credit, the lifetime learning credit is not based on the student's workload. It is allowed even if the student takes only one course. The lifetime learning credit is also not limited to students in the first four years of post-secondary education; expenses for graduate-level degree work or courses taken to acquire or improve job skills are eligible.

There is no limit on the number of years for which the lifetime learning credit can be claimed for each student. However, the amount you clan claim as a lifetime learning credit does not vary based on the number of students for whom you pay qualified expenses, meaning you can claim a maximum of $2,000 on your 2010 tax return regardless of how many students you pay qualified expenses for.

What is the amount of the lifetime learning credit?

The amount of the lifetime learning credit is 20% of the first $10,000 an individual pays for qualified education expenses for all eligible students in the family. The maximum amount of lifetime learning credit a taxpayer may claim for 2010 is $2,000. However, that amount may be reduced based on an individual's modified adjusted gross income. The lifetime learning credit is unavailable for individuals with modified adjusted gross income over $60,000 ($120,000 for married couples) and is reduced for individuals with gross income between $50,000 and $60,000 ($100,000 and $120,000 for married couples). The lifetime learning credit is unavailable for married couples filing separately.

For the purposes of the lifetime learning credit, qualified education expenses includes only tuition and fees required for enrollment.

How do I claim either credit?

To claim the American opportunity or the lifetime learning credit, the taxpayer simply files a completed Form 8863 with his or her Form 1040.

EDUCATION SAVINGS BONDS

What is an Education Savings Bond?

A Education Savings bond is a series EE bond issued after 1989 or a series I bond. These bonds offer unique advantages when used to pay for college but often do not provide the returns needed in order to accumulate the kind of cash necessary to pay for college.

Who can purchase an Education Savings Bond?

A bond can be issued either in an individual's name or jointly with a spouse. The purchaser must be at least 24 years old before the bond's issue date. Therefore, these bonds cannot be purchased in a child's name.

What are the tax advantages of an Education Savings Bond?

Bonds generally accumulate interest income on a tax-deferred basis. Therefore, they offer the advantage of tax-free compounding of interest. If redeemed to pay for qualified education expenses, all or part of the interest income may escape income tax.

How much income is excludable?

If the combined interest and principal from the bond that is redeemed during the year is less than the qualified education expenses for the year, a taxpayer can exclude all of the bond interest. If the combined interest and principal from the bond that is redeemed is more than the educational expenses, the taxpayer can exclude only part of the interest. For this purpose, qualified education expenses include tuition and fees required to enroll or attend an eligible educational institution. Qualified expenses do not include expenses for room and board or for courses involving sports, games or hobbies that are not part of a degree program. Additionally, the bonds must be redeemed in the year in which the owner pays these qualified education expenses.

Are there income limits?

Yes. For 2010, the interest exclusion is phased out if the taxpayer's modified adjusted gross income is between $70,100 and $85,100 (between $105,100 and $135,100 if your filing status is married filing jointly or qualifying widow(er)). An individual does not qualify for the interest exclusion if his or her modified adjusted gross income is equal to or greater than the upper limit.

How do I claim the exclusion?

A taxpayer must complete Form 8815 which calculates the exclusion and attach this form to his or her Form 1040.

For more information on educational savings opportunities, please contact Laura Hoexter, Chair of the Estate Planning and Probate Group at Helsell Fetterman LLP.

	529 Plan	Coverdell Education Savings Accounts	Irrevocable Trust	Qualifying U.S. Savings Bonds
Federal Income Tax *Grantor*	Non-deductible contributions	Non-deductible contributions	Non-deductible contributions	Tax-deferred for federal; tax-free for state
Federal Income Tax *Beneficiary*	Withdrawn earnings excluded from income to extent of qualified higher education expenses	Withdrawn earnings excluded from income to extent of qualified higher education expenses and qualified K-12 expenses before 2013 also excluded	Trust income distributed to the beneficiary will be reportable by the beneficiary and any income retained by the Trustee will be reportable by the Trustee	Certain post-1989 EE and I bonds may be redeemed federal tax-free for qualified higher education expenses
Federal Gift Tax *Grantor*	Contributions treated as completed gifts. Apply $13,000 annual exclusion, or up to $65,000 with 5-year election	Contributions treated as completed gifts. Apply $13,000 annual exclusion	Contributions treated as completed gifts. Apply $13,000 annual exclusion with proper Crummey Notices	No gift as qualifying bonds must be owned by the parent
Federal Estate Tax *Grantor*	Value removed from donor's gross estate; partial inclusion for death during a 5-year election period	Value removed from donor's gross estate	Value removed from donor's gross estate	Value included in bond owner's gross estate
Federal Financial Aid	Counted as asset of parent if owner is parent or dependent student	Counted as asset of parent if owner is parent or dependent student	Counted as asset of parent if properly drafted; may be considered an asset of the beneficiary	Counted as asset of bond owner
Able to Change Beneficiary	Yes, to another member of the beneficiary's family	Yes, to another member of the beneficiary's family	No, cannot be changed once executed. However, a Trust can name more than one beneficiary.	Not applicable
Time/Age Restrictions	None unless imposed by the program	Contributions before beneficiary reaches age 18; use of account by age 30	No limit	Bond purchaser must be at least 24 years old at time of bond issuance
Maximum Investment	Established by the program; many in excess of $300,000 per beneficiary	$2,000 per beneficiary per year combined from all sources	No limit	$5,000 face value per year, per owner, per type of bond
Investments	Menu of investment strategies as developed by the program	Broad range of securities and certain other investments	Grantor can specify in the Trust instrument how the funds should be invested; Trustee is free to invest the funds as the Trustee deems most appropriate within the guidelines set forth by the Grantor	Interest-earning bond backed by full faith and credit of U.S. government
Qualified Expenses	Tuition, fees, books, supplies, equipment, computer technology and special needs; room and board for minimum half-time students	Tuition, fees, books, supplies, equipment, computer technology and special needs; room and board for minimum half-time students; additional categories of K-12 expenses	Grantor designates guidelines for distributions and is free to define the limitation on distributions as he or she desires	Tuition and fees
Use for Nonqualifying Expenses	Withdrawn earnings subject to federal tax and 10% penalty	Withdrawn earnings subject to federal tax and 10% penalty	Trustee must make distributions within the guidelines set forth by the Grantor	No penalty; interest on redeemed bonds included in federal income
Income Restrictions	None	Ability to contribute phases out for incomes between $190,000 and $220,000 (joint filers) or $95,000 and $110,000 (single)	None	Interest exclusion phases out for incomes between $106,650 and $136,650 (joint filers) or $71,100 and $86,100 (single)

To learn more, contact our
Estate Planning & Probate Group

Helsell Fetterman LLP
Seattle 1001 Fourth Avenue, Suite 4200 Seattle, WA 98154
Bellevue 10900 NE Fourth Street, Suite 2300 Bellevue, WA 98004