CPA

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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

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Check the Numbers on 529 Plans

If you are saving for a child's college education or planning to help a grandchild pay for higher education, you should consider a 529 college savings plan, also known as a qualified tuition program (QTP). Every state and the District of Columbia offer 529 plans, which can deliver ample federal tax benefits (see Trusted Advice, "529 Basics" in this issue). Residents who contribute to their home state's plan often receive state tax breaks as well, such as deductions for the contributions.

Once you put money into a 529 plan, you must decide how to invest your funds. Typically, you can choose from a menu of investment options. Many parents and grandparents pick the "age-based" option and turn over the investment decisions to professional money managers.

From stocks to bonds

Age-based options shift the asset allocation as the plan beneficiary (a precollege student) grows older. For very young children, the allocation emphasizes stock funds. As the beneficiary grows older, the investment account evolves from stocks to bonds and cash equivalents.

Example: Doug and Laura Grant live in Missouri. When their daughter Ava is born, they set up an account in Missouri's 529 plan. The Grants choose the age-based option and select the "moderate" rather than the "conservative" or the "aggressive" portfolio.

Initially, Ava's 529 account is invested 80% in stock funds and 20% in bond funds. The stock fund allocation drops to 60% at age 6, 40% at age 11, and 20% at age 16. Money shifted from stocks goes to bond funds. When Ava reaches age 19, any money left in her 529 account will be 75% invested in bond funds and 25% in short-term investments, including money market funds. Going forward, this age-based option will hold no stocks.

History lessons

Other states' age-based options are generally similar to those offered by

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529 Basics

- Contributions to 529 college savings plans are not tax deductible.
- Inside a 529 plan, any investment income is tax free.
- Withdrawals from a 529 plan are tax free to the extent they are used to pay the beneficiary's higher education expenses in the same calendar year.
- Qualified higher education expenses include tuition, fees, books, supplies, and equipment. Room and board expenses also can be qualified higher education expenses if the youngster is enrolled at least part time.
- Withdrawals from a 529 plan that are not used for qualified higher education expenses are subject to income tax plus a 10% penalty.

Missouri. This strategy stems from past performance in the investment markets. For investments of 12 –18 years, stocks usually have done better than bonds or cash equivalents.

Recently, the U.S. stock market has been battered by severe bear markets—in 2000–2002 and 2008–2009. Even so, Morningstar's Ibbotson subsidiary reports that returns on large-company U.S. stocks were 2.0% per year for the 12 years through 2010, 6.8% per year for the last 15 years, and 8.1% per year for the last 18 years. In most of the 12- to 18-year periods since records became available, stocks have been strong performers.

However, as the past decade has shown, stocks can fall sharply in a short time period. Therefore, it's risky to have a college fund for a teenager that's too heavily invested in stocks. When a child reaches age 18 or 19, he or she may be ready to go to college. A 529 account that shrinks in a bear market just before high school graduation might offer less financial support than the family has anticipated. Moreover, there is no guarantee of a market rebound and a 529 plan recovery during the four years or so that the student attends college.

Determining the differences

Age-based investment options vary from state to state. As noted, there may be different choices within the age-based plan in a given state. Missouri's "aggressive" option, for instance, keeps a 40% allocation to stocks through age 18, whereas the "conservative" option has only 20% stocks at age 11 and no stocks at all from age 16 on. Therefore, you should drill down to see exactly what you'll be getting if you choose an age-based 529 plan option. ■

Coverdell Accounts Can Cover Precollege Costs

Qualified tuition programs, known as 529 plans, can help you build a college fund with ample tax benefits, as explained in the previous article "Check the Numbers on 529 Plans." Most 529 plans allow you to contribute tens of thousands, even hundreds of thousands of dollars. It's true that gift tax rules apply, but a special provision of the tax code encourages gifts of up to five times the annual gift tax exclusion amount in a single year. The annual exclusion for 2011 is $13,000, so you can give up to $65,000 to a 529 plan for a specific beneficiary. As long as you file gift tax returns each year for five years, no gift tax will be due because the special provision allows givers to spread the exclusion amount over five years. Grandparents might consider such a strategy to move assets from their taxable estate.

By comparison, contributions to Coverdell Education Savings Accounts (ESAs) seem paltry. Contributions for each student are capped at $2,000 per year. Nevertheless, parents and grandparents may want to fully fund a Coverdell ESA for precollege children each year before putting any money into a 529 plan.

Assessing the advantages

Two main reasons for starting your college funding each year with a $2,000 Coverdell ESA contribution are as follows:

1. **Investment flexibility.** With a 529 plan, you're limited to the investment options on the menu.

A Coverdell ESA, on the other hand, is like an IRA, so you can pick your own investments. Many banks, brokerage firms, mutual fund families, and insurance

Did You Know?

In 2010, the median sales price of existing single family homes was $173,300. Although this price was 22% lower than the peak price of $221,900 in 2006, it was still about 18% higher than the 2000 median sales price of $147,300 and almost 80% higher than the 1990 median price of $97,300.

Source: National Association of Realtors companies offer Coverdell ESAs. You can choose among a broad range of funds and individual securities for your money.

2. **Distribution alternatives.** Like 529 plans, Coverdell ESAs are funded with aftertax dollars, and investment income is untaxed. Distributions may be tax free. Distributions from a 529 plan, however, are tax free only if you use the money for post-high school education. Coverdell distributions are tax free if used to pay for higher education expenses, but they also can be tax free if you use the money for education-related expenses while the beneficiary is in kindergarten through high school.

Example 1: Paul and Jennifer Wilson set up a Coverdell ESA for their newborn son, Ethan, and contribute $2,000 each year. They decide to send Ethan to private school, starting in first grade. If needed, the Wilsons can tap Ethan's Coverdell account to pay for his private school tuition.

Clearing the hurdles

Some drawbacks exist to Coverdell accounts. Married couples with modified adjusted gross income (MAGI) over $190,000 cannot contribute the full $2,000 to Coverdell accounts; for single taxpayers, that MAGI limit is $95,000. With MAGI up to $220,000 or $110,000, respectively, your ability to make partial Coverdell ESA contributions phases out altogether. Even if your income is over those limits, however, you can give $2,000 per student to a lower income relative, including the child who will be the Coverdell beneficiary. Then the recipient of that gift can use the money to open a Coverdell account and make a full Coverdell ESA contribution with MAGI below $190,000 (joint returns) or $95,000 (single).

Also, Coverdell ESAs must be liquidated within 30 days after the beneficiary turns age 30 (unless the beneficiary is a special needs beneficiary). Distributions not used for qualified higher education expenses by then will be subject to income tax plus a 10% penalty. To avoid this, you can roll over the amount in one beneficiary's Coverdell ESA to a younger relative's Coverdell ESA, tax free.

Example 2: Ron and Jan Hansen set up a Coverdell ESA for their son Craig. When Craig finishes his education at age 29, he has $5,000 left in the account. Craig withdraws the $5,000 and contributes to a Coverdell ESA established for his younger sister Lucille. No tax is due on these transactions.

In reality, you should be able to spend down all the amounts in a Coverdell ESA before the original beneficiary reaches age 30.

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Taking Credits for Higher Education

In 2009, Congress replaced the Hope Scholarship tax credit with the more valuable American Opportunity tax credit. The latter credit was scheduled to expire after 2010 but was extended at year-end, along with many other tax benefits. Therefore, the American Opportunity credit remains the primary tax credit available for higher education in 2011 and 2012.

The maximum American Opportunity tax credit is $2,500 per student. To qualify for the maximum credit, you must spend at least $4,000 per student in 2011. You must spend this money for a student in his or her first four years of post-high school education. The money you pay for tuition and related fees counts for calculating the tax credit, along with outlays for necessary books, supplies, and equipment. Room and board costs do not count.

Example 1: Carl and Diane Hunter have a son who is a sophomore in college this year and a daughter who is a college senior. They spend $12,000 on each student's qualifying expenses in 2011. Thus, they can claim two American Opportunity credits of $2,500 each, for a total of $5,000. For most taxpayers, the American Opportunity credit is 40% refundable.

Credit constraints

High income taxpayers can't use the American Opportunity tax credit. To get the full credit, your MAGI must be no more than $80,000 if you are a single taxpayer or $160,000 if you are married and file a joint tax return. The American Opportunity tax credit phases out with MAGI up to $90,000 (single) or $180,000 (joint returns).

In addition, any money you withdraw from a Coverdell Education Savings Account or a 529

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plan won't count for calculating the credit.

Example 2: Jennifer Thomas pays $10,000 for her son Nick's college bills in 2011. Jennifer's MAGI is $75,000, so she qualifies for a full American Opportunity tax credit. However, Jennifer withdraws $8,500 from a 529 plan in 2011. If Jennifer counts that as a tax-free withdrawal, she will have only $1,500 of expenses that can be offset by the American Opportunity tax credit. If Jennifer counts $4,000 of expenses to be offset by a full American Opportunity tax credit, she will have only $6,000 of expenses that can count as a qualified 529 withdrawal.

As you can see, the interplay between a 529 plan, Coverdell account withdrawals, and the American Opportunity tax credit might not be simple. Our office can help you calculate the most tax-efficient amounts to withdraw and the most tax-efficient way to claim education related benefits on your tax return.

Later learning

You may be able to use a Lifetime Learning tax credit instead of the American Opportunity tax credit; however, the Lifetime Learning credit is less valuable. The American Opportunity tax credit can save as much as $2,500 *per student*, but the Lifetime Learning credit saves no more than $2,000 *per tax return*. Moreover, the income limits for the Lifetime Learning credit are stricter.

Why bother with the Lifetime Learning credit? It may be the only education-related tax credit you can use. The American Opportunity tax credit can be used only during a student's first four years of post-high school education, and only if that student is pursuing an undergraduate degree or a similar credential. The Lifetime Learning credit can be used if you incur other expenses at any time, such as outlays for graduate school or career advancement courses. A taxpayer cannot take an American Opportunity credit and a Lifetime Learning credit for the same child in

the same year; however, it's possible to take an American Opportunity credit for one child and a Lifetime Learning credit for another child on the same tax return.

As mentioned, the Lifetime Learning credit also has income requirements. For 2011, the maximum $2,000 credit phases out with MAGI of $51,000–$61,000 (single) or $102,000–$122,000 (joint returns).

Finding a Use for the Tuition and Fees Deduction

The tax code offers multiple ways to offset the costs of higher education. As explained in the previous article "Taking Credits for Higher Education," taxpayers can use the American Opportunity or the Lifetime Learning tax credit this year. As another choice, you might be able to take the tuition and fees deduction. However, if you send a child to college and claim either the American Opportunity or Lifetime Learning tax credit for a student's expenses, you cannot take the tuition and fees deduction for the same student's expenses that year.

For most taxpayers, the tuition and fees deduction will be the third choice. The maximum deduction is $4,000. To take that deduction, you must spend at least $4,000 on post-high school tuition, fees, books, supplies, and so forth. You also must have MAGI that's not more than $65,000 as a single taxpayer, or not more than $130,000 if you're married and file a joint return.

If your MAGI is even $1 over the $65,000 or $130,000 thresholds, your maximum deduction drops to $2,000. With MAGI over $80,000 (single) or $160,000 (joint), you can't take this deduction at all. With those requirements, taxpayers who qualify for the maximum $4,000 will not be in a tax bracket higher than 25%. Therefore, the maximum federal income tax saving with the tuition and fees deduction is $1,000: 25% of $4,000. You can save up to $2,000 with the Lifetime Learning credit and up to $2,500 per student with the American Opportunity credit.

Consequently, taxpayers will claim this deduction only when they don't qualify for either higher education tax credit. When might that occur? You might be paying the expenses for a student (including yourself) who is not in the first four years of post-high school education, not pursuing an undergraduate degree, and not going to school at least part time. All of those conditions must be met to qualify for the American Opportunity credit, so you can't take that credit if the student doesn't meet those criteria.

You can claim the Lifetime Learning credit without having to meet the conditions required for the American Opportunity credit; however, the Lifetime Learning credit phases out with MAGI of $51,000–$61,000 (single) or $102,000–$122,000 (joint returns). If your income is just a little too high to meet the requirements for the Lifetime Learning credit and you spent money for education at an accredited institution, you may be able to use the tuition and fees deduction. ■

Coping With the Kiddie Tax

You may believe that shifting income from parent to student is a tax-efficient way to build an education fund. You might, for instance, give taxable bonds to your children so they can receive interest in a low tax bracket. Similarly, you might give appreciated assets to youngsters, who can sell them and owe little or no tax on the gains.

Such tactics can be useful, but they are limited by the so-called "kiddie tax." This tax code provision caps the amounts of unearned income that can be taxed at a youngster's rate. Excess amounts are taxed at the parents' rate, so there may be no family tax benefit.

Kid stuff

Recent legislation has changed the kiddie tax rules. In 2011

- everyone under age 18 is considered a "kiddie."
- the same is true for full-time students under age 24, if their earned income is less than half of their support. Here, *support* is the total spent on a student's behalf during the year.
- 18-year-olds are still considered kiddies even if they are not full-time students, as long as their earned income is less than half of their support.

In 2011, individuals subject to those rules owe no tax on unearned income up to $950. The next $950 of unearned income will be taxed at the child's rate, which will be no more than 10%. Over $1,900, all unearned income will be taxed at the parents' rate. The kiddie tax limits change periodically to keep up with inflation, so the $1,900 limit might move up to $2,000, $2,100, and so forth in the future.

Weighing the tradeoffs

Even with the kiddie tax limits in place, some families might find tax benefits in income shifting.

Example 1: John and Karen Jackson hold $35,000 in a taxable bond fund yielding 5%. When their daughter Sarah is born, they transfer their shares in that fund to the newborn. If Sarah receives $1,750 (5% of $35,000) this year, she will owe no tax on the first $950 and $80 on the next $800, at a 10% rate. This can go on every year, permitting Sarah to build up an education fund at a very low tax rate.

Example 2: Brett and Caroline Morgan plan to sell some mutual funds this year to raise money for their son Tyler's college bills. They hold ABC Fund, bought for $10,000 in 2009 and now trading at a price that will bring $11,500 on a sale. They give those shares to Tyler, who can sell them and report the $1,500 long-term capital gain. Tyler has minimal other taxable income this year and qualifies for the 0% tax rate, so no tax is due on the sale.

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Trusted Advice

Student Loan Deductions

- Interest paid on student loans may be tax deductible.
- The maximum deduction is $2,500 per year.
- For a full deduction, you must have modified adjusted gross income (MAGI) that's not more than $60,000, or not more than $120,000 if you're married and file a joint return. The deduction phases out with MAGI up to $75,000 (single) or $150,000 (joint returns).
- You can't take any tax deduction if the loan was from a relative or a 401(k) plan.
- You might be able to take a larger tax deduction if you're willing to tap a home equity line of credit (HELOC) to pay college costs. On a HELOC, the interest on loans up to $100,000 may be deductible.

Education Expenses

According to the College Board, the average price of tuition and fees in 2010–2011 was $7,605 for in-state students at public four-year institutions and $27,293 at private, nonprofit four-year colleges and universities.

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Coverdell ESA tax benefits are scheduled to be reduced in 2013. However, Congress just extended those tax benefits, so there may be a further extension in the future. If Congress does not act, and Coverdell ESA tax breaks are trimmed to the point where you're dissatisfied, you can roll over the amount in a Coverdell ESA to a 529 plan of your choice. ■

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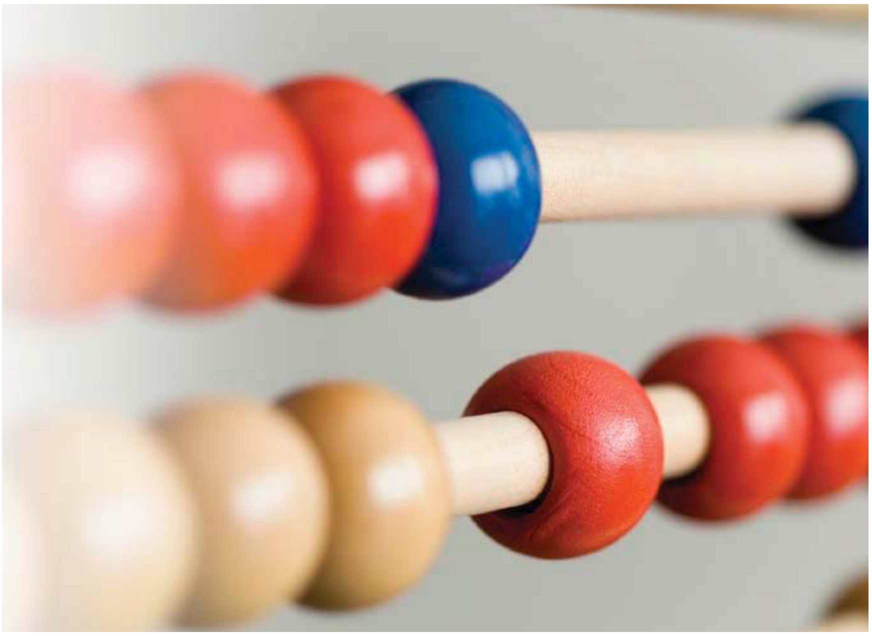
Do these maneuvers make sense? Any tax savings can help families bear the increasing costs of college.

There are drawbacks, however. Some asset transfers may have to be reported on a gift tax return. Holding assets in a student's name might reduce eligibility for need based financial aid. Perhaps most important, assets transferred to a youngster eventually will be controlled by that youngster, who may spend the money on things other than higher education. Our office can help you quantify the tax savings available through income shifting so you can decide whether these tactics are worthwhile. ■



TAX CALENDAR

AUGUST 2011

August 1

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2011. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2010.

August 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2011. This due date applies only if you deposited the tax for the quarter in full and on time.

August 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

SEPTEMBER 2011

September 15

Individuals. If you are not paying your 2011 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2011 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. File a 2010 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic 6-month extension.

Deposit the third installment of estimated income tax for 2011. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2010 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic 6-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

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