

College Planning in the Wake of New Tax Laws

Planning for college has never been easy. But such planning became a bit easier when President Bush signed the TIPRA and DRA into law earlier this year. Among other things, DRA and TIPRA changed the treatment of pre-paid tuition plans and 529 plans, two popular vehicles Americans use to save for and pay for college.

Chief among the changes are those that pertain to the so-called "kiddie tax." Effective in 2006, the new law calls for the "kiddie tax" to remain in effect until a child turns 18. Previously, unearned income attributable to children age 14 and older was usually taxed at the child's tax rate. The new tax law, however, raises the age to 18 effective January 1, 2006. Exceptions apply for minor children who are married and file a joint tax return, and distributions from certain qualified disability trusts.

This change affects parents and grandparents who were or continue to use custodial accounts such as UTMAs (Uniform Transfer to Minors Act) or UGMAs (Uniform Gift to Minors Act) for college savings instead of 529 college savings plans. At present, UTMA and UGMA dollars are considering the child's asset in the financial aid formula. But selling funds, or at least selling funds that have appreciated in value, in an UTMA or UGMA prior to a child turning 18, could create a significant tax bill. What's more, assets in UGMA and UTMA accounts become the child's at the age of maturity, which varies by state.

For many parents and grandparents, the new law makes 529 plans a more viable savings vehicle. With a 529 plan, contributions will grow tax-free and withdrawals are tax-free through 2010 as long as they are used for qualified education expenses. In addition, financial planners note that with 529 plans, the parent or grandparent controls the money.

Of course, parents and grandparents who established UTMA and UGMA accounts to pay for college education do have options. Under the act, UTMA or UGMA assets can be invested in a 529 plan, although assets have to be liquidated and cash invested in the plan. Doing so may create a tax burden, but financial planners note that it may be more than offset by preferential treatment of 529 plans in the financial aid formula. A tax analysis should be performed to determine the impact.

According to SavingforCollege.com, 529 plans do indeed receive preferential treatment. Sometimes referred to as the "529 loophole," the new law removes student-owned 529 plans and Coverdell education savings accounts from the expected family contribution ("EFC") in the federal financial aid formula. A 529 account or Coverdell ESA is considered an asset of the account owner; however, 529 accounts or Coverdell ESAs owned by a dependent student are excluded from the Free Application for Federal Student Aid or FAFSA. Most undergraduates are dependents for FAFSA purposes.

This is exceptional treatment, reports SavingforCollege.com. Under the federal financial aid rules, college savings plans are counted as an asset of the parent (if the parent is the account owner) and assessed at a rate of 5.6 percent. This means that 5.6 percent of the funds are deemed available for college expenses in the year a student applies for aid. By contrast, 35 percent of assets owned by the student are used to calculate the EFC.

In addition, parents and grandparents who have been using prepaid tuition plans to save for their children's college education received some good news on July 1, 2006 when the federal government began treating 529 prepaid tuition plans the same as 529 college savings plans for financial aid purposes.

Distributions (withdrawals) from a college savings plan that are used to pay the beneficiary's education expenses are not counted as either parent or student income. Prepaid tuition plans will now be treated the same way.

By way of background, prepaid tuition plans prior to July 1, 2006 were treated differently than college savings plans under the government's financial aid formula. A prepaid tuition plan wasn't counted as an asset of either parent or student, but any distributions from the plan were considered a "resource" that reduced the cost of attendance at any given college. And that resulted in a corresponding dollar-for-dollar reduction in financial aid. That is, every dollar that flowed out of a prepaid tuition plan reduced the beneficiary's aid award by one dollar. The new financial aid rules ensure that both types of 529 plans will be treated equally.

August 2006— This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Marnie Aznar, MBA, CFP®, a local member of FPA