http://grandparenting.org/resource/helping-with-your-grandchilds-college-tuition/

Helping With Your Grandchild's College Tuition

Paying for college has never been easy, especially for families with competing financial goals. To further the challenges posed to parents, the cost of attending college is accelerating at astonishing rates. According to the College Board's "Trends in College Pricing" 2000 report, the cost of attending a four-year private university rose roughly 5.2% from 1999 to 2000. At that rate, estimates for the total cost of attendance at a private college or university reach $250,000 by the year 2020. But there is cause for hope—saving for college is becoming more accessible than ever before. New tax legislation passed on June 7, 2001 has created new financial opportunities for investors. Specifically, the legislation has improved the benefits of two existing, tax-advantaged college savings programs: 529 College Savings Plans and Education Savings Plans.

529 COLLEGE SAVINGS PLANS:

The 529 Plan is a versatile investment option available for college savings. 529 Plans, also known as Qualified State Tuition Plans, are state-sponsored investment programs that qualify for special tax treatment under section 529 of the Internal Revenue Code. These plans typically involve an agreement between a state government and one or more asset management companies. Recent tax law changes also now allow educational institutions (public or private) to enter into an agreement with an asset management company and establish a 529 plan. Investors can open an account with the asset management company and deposit funds to be used for college expenses. The contributor of the account becomes the account owner and controls withdrawals of assets. The person for whom the plan is set up becomes the beneficiary.

Investors enjoy the benefits of investing their education savings in professionally managed portfolios. Under the new tax laws, assets grow tax-free once invested and remain under the control of the account owner rather than transferring to the child at the age of majority. Any U.S. citizen can participate in a 529 Plan, and the funds can be used at any accredited college or university.

WHAT ARE THE TAX BENEFITS OF ENROLLING IN A 529 PLAN?

Although there is no federal tax deduction for contributions to the account, the funds grow tax-free until they are withdrawn. They remain tax free if used for qualified education expenses. Unlike other tax-advantaged vehicles, 529 Plans have no income limitations on who can contribute, making them available to all investors. Contributions to 529 Plans also qualify for the $10,000 ($20,000 for married couples) annual gift tax exclusion with one beneficial modification: you are allowed to lump together five years of gifts, provided you do not make additional gifts within those five years. This means you may give up to $50,000 ($100,000) at one time.

QUALIFIED WITHDRAWALS

Qualified withdrawals include expenditures for any higher education expenses including undergraduate and graduate school tuition fees, books, equipment, room, board and supplies required for enrollment at any accredited institution. Tax reforms increased the limits on room and board fees that 529 Plan assets can pay. The room and board costs of the particular institution now determine these limits, even for students who live off campus.

NON-QUALIFIED WITHDRAWALS

A non-qualified withdrawal occurs when assets are withdrawn for any reason other than to pay for a qualified higher education expense for the beneficiary. The earnings portion of the withdrawal will be taxed at ordinary income tax rates to the account owner, not to the beneficiary. In addition, a program-imposed penalty must be paid. In most 529 Plans, the penalty is 10% of the earnings portion of the withdrawal.

In the event of death or disability of the beneficiary, the program will not charge a penalty for withdrawals. Also, no penalty will be assessed if the refund is made because the beneficiary received a scholarship (which reduces the tuition needs). Any earnings will be taxed at the account owner’s ordinary income tax rate, not at the beneficiary’s rate.

WHAT HAPPENS WHEN EDUCATION FUNDS ARE NOT NEEDED OR THE BENEFICIARY DECIDES NOT TO ATTEND COLLEGE?

If funds in a 529 Plan are not needed for education, there are several options available. The account owner can redeem assets for himself as a non-qualified withdrawal and pay ordinary income taxes and a penalty. If the beneficiary decides not to go to college, you could leave the money in the account for use in the future, either by the beneficiary if he/she eventually decides to pursue a higher degree or by the beneficiary's children. You could also keep the account intact and change the beneficiary by "rolling over" the account to a "family member" of the original beneficiary. The definition of "family member" includes a beneficiary's spouse, children, brothers, sisters, nephews and nieces and any spouse of such persons. A change in the tax law extends the definition to include first cousins.

CONTROLLING ASSETS

The account owner has the right to change the beneficiary, to determine the amount and timing of withdrawals and even to reclaim the assets. For long-term planning purposes, account owners should consider putting a clause in their will to delegate the power to control the 529 Plan distributions or assign a successor account owner when establishing the account.

EDUCATION SAVINGS PLANS:

Many investors know about tax advantages associated with Individual Retirement Accounts (IRAs), but you may not be as familiar with Education IRAs, now called Education Savings Accounts (ESAs). Like IRAs for retirement, ESAs have income limitations, so not all investors are able to benefit from this savings program. These plans offer you the opportunity to save after-tax dollars toward the education of a beneficiary of your choosing. These funds then grow tax-free until the beneficiary uses the funds. Withdrawals used for qualified education expenses remain tax free.

The amount you are allowed to save per year in an ESA has risen from $500 to $2,000. In addition, funds from an ESA may now be used to pay for elementary and secondary school costs, computer technology, uniforms, extended day programs, certain room and board expenses and Internet access for the beneficiary while he or she is in school. The most important reform made to ESAs under the new tax laws is the ability to coordinate savings with a 529 Plan, allowing families to save more than ever before.

PUTTING IT ALL TOGETHER

The new tax laws make it easier for most Americans to save for their children's educations. The tax-free growth offered by 529 Plans and ESAs and their new ability to coordinate, covering education expenses from kindergarten through college, make these plans more flexible. Contact a qualified financial advisor to see how an education savings program fits into your investment plan.

Thanks for this article to Louis F. Mosca, Vice President of Investments at Legg Mason Wood Walker Inc., a diversified financial services and securities brokerage firm that is a member of the New York Stock Exchange and SIPC.