

For Parents: Tax-Favored Education Savings Opportunities

With the increasing education costs for college and beyond, Congress and the State of Minnesota have expanded the incentives available for saving ahead of time. In addition to federal incentives, primarily for higher education, the State of Minnesota offers a credit and deduction for certain expenses incurred in K-12 education.

Series EE U.S. savings bonds offer two tax-savings opportunities when used to finance your child's college expenses: First, you don't have to report the interest on the bonds for federal tax purposes until the bonds are actually cashed in; and second, interest on "qualified" Series EE (and Series I) bonds may be exempt from federal tax if the bond proceeds are used for qualified college expenses. But if your adjusted gross income (AGI) is too high, the exemption is phased out. For bonds cashed in during 2010, the exemption starts to "disappear" when your AGI hits \$105,100 for joint return filers (\$70,100 for singles) and is gone entirely if your AGI is at \$135,100 (\$85,100 for singles).

A qualified tuition plan ("529 Plan") allows you to buy tuition credits or contribute to an account set up to meet a child's higher education expenses. Contributions aren't deductible, and the contributions are taxable gifts to the child, but they are eligible for the annual \$13,000 gift tax exclusion (and you can make five years' worth of gifts in one year). Earnings on the contributions accumulate tax-free, and distributions are tax-free if used to pay qualified higher education expenses for college, graduate or vocational school. Expenses include tuition, fees, books, supplies and equipment, expenses for special needs and, if the student is enrolled at least half-time, room and board. If not used for qualified higher education, untaxed earnings are subject to income tax plus a 10% penalty tax. If you invest in the Minnesota College Savings Plan, a matching state grant of up to \$400 is available if the beneficiary's family's income is less than \$80,000.

You can establish Coverdell education savings accounts (formerly called "Education IRAs") and make contributions of up to \$2,000 for each child under age 18 or with special needs. The right to make these contributions begins to phase out once your MAGI is over \$190,000 on a joint return. If the income limitation is a problem, you can gift to the child and have the child make a contribution to his or her own account. Although the contributions aren't deductible, funds in the account aren't taxed, and distributions are tax-free if spent on education expenses, including K-12 costs.

You can take a Hope tax credit of up to \$2,500 a year per student for the first two years of college (a 100% credit for the first \$2,000 in tuition, and a 25% credit for the second \$2,000). You can take a Lifetime Learning credit of up to \$2,000 per family for every additional year of college or graduate school (a 20% credit for up to \$10,000 in tuition). The Hope Credit is phased out in 2010 for couples with incomes between \$160,000 and \$180,000, while the Lifetime Learning Credit phases out between \$100,000 and \$200,000.

Through 2009 taxpayers were permitted to take an above-the-line deduction for college tuition and related expenses that they pay. In 2009, for married taxpayers with MAGI of up to \$130,000 for joint return filers, the maximum deduction is \$4,000. For taxpayers between \$130,000 and \$160,000, there is a reduced deduction of \$2,000 available. See your tax advisor about any extension to 2010.

Scholarships are exempt from income tax if certain conditions are satisfied. The scholarship must not be compensation for services, and it must be used for tuition, fees, books, supplies and similar items (and not for room and board). Beginning in 2002, a scholarship received under a health professions scholarship program may be tax-free even if the recipient is required to provide medical services.

You can deduct interest on loans used to pay for your child's education at a post-secondary school, including some vocational and graduate schools. The deduction is an above-the-line deduction and the maximum is \$2,500. However, the deduction phases out for taxpayers who are married filing jointly with MAGI between \$120,000 and \$150,000.

You can withdraw from your IRA (including a Roth IRA) at any time to pay college costs without incurring the 10% early withdrawal penalty that usually applies to withdrawals from an IRA before age 59½. However, the distributions are subject to income tax under the usual rules for IRA distributions. Some qualified plans, however, either don't permit withdrawals or restrict them.

The Minnesota incentives apply for K-12 expenses. A tax credit is available for those with 1-2 children and household income less than \$37,500. This increases by \$2,000 for each additional child. For those above the limit, there is a deduction available, regardless of income. If you qualify for the credit, you may claim 75% of your expenses, up to \$1,000 per child. If you take the subtraction, you can deduct up to \$1,625 per qualifying child in grades K-6, and \$2,500 for a qualifying child in grades 7-12. There is no family maximum subtraction.

Strategies for gifting to children might also include custodial accounts ("Uniform Gifts to Minors Act accounts), 2503(c) annual exclusion trusts, and 2503(b) crummey trusts. More about these techniques is described on our Estate Planning page.

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