

Information for Better Living

Education Savings Programs: What You Need to Know

Saving for education costs (both college and K-12 private school tuition) is a major financial goal for many families. Two of your options include 529 programs and Coverdell Education Savings Accounts. Here are some important facts and guidelines for both.

529 College Savings Programs

There are two main types of 529 programs – college savings plans and prepaid tuition plans – and each state plan has its own terms and features. The specifics of each plan vary greatly. So before you sign on, get the details about the investments, fees, and restrictions of the state plans you're considering. Go to www.collegesavings.org to find out more about 529 plans.

Q: Who can contribute to a 529 plan?

In general, 529 plans don't have any eligibility income limitations. Any adult – parents, grandparents, other relatives, and friends – can open an account and name a beneficiary.

Q: What are the tax benefits?

When you make qualified withdrawals from a 529 plan your earnings are free from federal income tax. State rules governing 529 programs vary. Some allow state residents to deduct the full or a partial amount of their contribution from state income taxes. And most states allow residents to exempt earnings from state income tax. Some plans are open to residents of all states. Importantly, however, out-of-state participants may not get the state tax breaks.

Q: What are 529 college savings plans?

College savings plans allow you to save money in a special college savings account for a student's qualified higher education expenses at any eligible educational institution.

Qualified higher education expenses include tuition and fees, books and supplies, and room and board for students enrolled at least half time. According to the IRS, the definition

of eligible educational institution includes virtually all U.S. accredited public and privately owned colleges, universities, and vocational schools. Each state sets its own lifetime contribution limit per beneficiary, generally ranging from about \$50,000 to \$368,000.

College savings plans provide variable rates of return based on the investments you choose from the available options. Your account value may increase or decrease based on the performance of your investments, which include stock, bond, and money market mutual fund options. Most plans offer safer fixed options designed to preserve your principal and provide a fixed rate of return.

Q: What are prepaid tuition plans?

Prepaid tuition plans allow you to pay tuition in advance and lock in the cost based on today's tuition prices.

You can use savings in these plans for tuition at any eligible public university or private college in the country. The amount, however, is based on tuition costs at a state's public universities. Therefore, if your child doesn't attend an in-state school and there's a difference between the prepaid tuition plan price and the current out-of-state tuition cost, you may have to pay the difference.



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Q: What if my child or grandchild doesn't attend college or I withdraw my money for non-college use?

If the beneficiary doesn't attend college, you may defer the account for later use or transfer it to another member of your family. If you use your savings for non-education expenses, you'll owe federal income taxes on the earnings, generally at your income tax rate. Plus, you'll incur a 10% federal penalty tax on earnings, unless an exception applies. The exceptions include a student's disability, death, or receipt of a scholarship.

Q: How do contributions to a 529 plan affect a student's financial aid eligibility?

Assets in a 529 plan may reduce a child's future eligibility for needs-based financial aid. The impact depends on your financial situation, the type of plan (prepaid or college savings), the type of aid, and the plan owner.

Coverdell Education Savings Accounts

Q: What are education savings accounts (formerly named Education IRAs)?

You can contribute up to \$2,000 per year to an education savings account per child under age 18. Although contributions aren't tax deductible, earnings accumulate tax deferred and withdrawals to pay qualified education expenses are free from federal taxes.

The child is the beneficiary and owner of the account. However, the parent or legal guardian establishes and controls the account. The contribution deadline for a given taxable year is April 15 of the following year. Contributions are not allowed after the beneficiary reaches age 18 (except for special needs beneficiaries).

Q: What are qualified education expenses?

Qualified higher education expenses include undergraduate and graduate tuition, fees, books, supplies, equipment, and services for special needs beneficiaries required for attendance at eligible educational institutions. Some room and board expenses also qualify if a student attends college at least half time.

Qualified education expenses also include qualified public and private elementary and secondary education expenses. Specifically, this includes expenses incurred while the beneficiary is in kindergarten through 12th grade at a public, private, or religious school.

Q: What are the eligibility requirements?

If you're a married taxpayer who files jointly with modified adjusted gross income under \$190,000, you qualify for the full \$2,000 contribution. If your income is between \$190,000 and \$220,000, you qualify for a partial

contribution. If you're a single taxpayer, these limits are \$95,000, and between \$95,000 and \$110,000 respectively.

Parents, grandparents, children themselves, and anyone else who meets the income limits, are eligible to contribute to an education savings account on behalf of a child under age 18 (total contributions in all accounts cannot exceed \$2,000 a year).

Q: What if my child doesn't use the money for college?

If your child doesn't attend college, you're allowed to roll the account over to other members of your child's family who are under age 30, without triggering taxes or penalties. Any money remaining in the account at the time your child turns 30 must be distributed (except for special needs beneficiaries). If the money isn't used for educational purposes and is distributed when your child turns 30, the earnings will be included in your child's gross income and subject to income taxes, as well as a 10% tax penalty (there are some exceptions).

Q: How will contributions to an education savings account affect other available tax breaks and my child's eligibility for needs-based financial aid?

If you're eligible, you can claim the Hope credit or Lifetime Learning credit in the same taxable year you take qualified withdrawals from an education savings account for the same student.

If you're eligible, you can make a contribution to both an education savings account and a 529 college savings plan for the same beneficiary, in the same year.

Currently, when determining a student's eligibility for needs-based federal financial aid, the value of an education savings account is counted as an asset of the account owner, which is typically a parent.

This article is not intended as tax advice. Obtain appropriate professional advice regarding your circumstances.

Please note: Certain ESA benefits may expire after 2010 (dependent on Congressional action.) K-12 expenses will no longer qualify. The annual contribution limit will be reduced to \$500 and withdrawals will not be tax free in any year in which a Hope Credit or Lifetime Learning Credit is claimed for the beneficiary. If this is a concern for you, you may want to consider moving assets from your child's ESA into a 529 plan. Please see a financial advisor for details.