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ACCOUNTANCY CORPORATION

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Tax Planning for College

Dear Client,

As a parent with college-bound children, you are concerned with setting up a financial plan to fund future college costs. If your children are already college age, your goal is to pay for current or imminent college bills. We'd like to address both of these concerns by suggesting several approaches that seek to take maximum advantage of tax benefits to minimize your expenses.

Planning for college expenses

In some cases, transferring ownership of assets to children can save taxes. You and your spouse can transfer up to $38,000 in 2025 ($36,000 in 2024) in cash or assets to each child with no gift tax consequences. And if your child isn't subject to the "kiddie tax," the child is taxed on income from assets entirely at the child's lower tax rates-as low as 10% (or 0% for long-term capital gain).

However, where the kiddie tax applies, the child's investment income above a certain threshold is taxed by applying the parents' rate to the child's investment income above a certain threshold, instead of the lower rate that would apply for a single individual.

The kiddie tax applies if: (1) the child hasn't reached age 18 before the close of the tax year or (2) the child's earned income doesn't exceed one-half of his or her support and the child is age 18 or is a full-time student age 19 to 23.

A variety of trusts or custodial arrangements can be used to place assets in your children's names. Note, it's not enough just to transfer the income, e.g., dividend checks, to your children. The income would still be taxed to you. You must transfer the asset that generates the income to the children's names.

Tax-exempt bonds

Another way to achieve economic growth while avoiding tax is simply to invest in tax-exempt bonds or bond funds. Interest rates and degree of risk vary on these, so care must be taken in selecting your particular investment. Some tax-exempts are sold at a deep discount from face and don't carry interest coupons. Many are marketed as college savings bonds. A small investment in these so-called zero-coupon bonds can grow into a fairly sizable fund by the time your child reaches college age. "Stripped" municipal bonds (munis) provide similar advantages.

Series EE U.S. savings bonds

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.

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Qualified tuition programs (529 plans)
A qualified tuition program (also known as a "529 plan") allows you to buy tuition credits for a child or make contributions to an account set up to meet a child's future higher education expenses. Qualified tuition programs can be established by state governments or by private education institutions.

Contributions to these programs aren't deductible. The contributions are treated as taxable gifts to the child, but they are eligible for the annual gift tax exclusion ($19,000 for 2025, $18,000 for 2024). A donor who contributes more than the annual exclusion limit for the year can elect to treat the gift as if it were spread out over a five-year period.

The earnings on the contributions accumulate tax-free until the college costs are paid from the funds. Distributions from qualified tuition programs are tax-free to the extent the funds are used to pay "qualified higher education expenses"-which can include up to $10,000 in expenses for tuition for an elementary or secondary public, private, or religious school. Distributions of earnings that aren't used for "qualified higher education expenses" will be subject to income tax plus a 10% penalty tax.

Coverdell education savings accounts
You can establish Coverdell ESAs (formerly called education IRAs) and make contributions of up to $2,000 for each child under age 18. This age limitation doesn't apply to a beneficiary with special needs, defined as an individual who because of a physical, mental or emotional condition, including learning disability, requires additional time to complete his or her education.

The right to make these contributions begins to phase out once your AGI is over $190,000 on a joint return ($95,000 for singles). If the income limitation is a problem, the child can make a contribution to his or her own account.

Although the contributions aren't deductible, income in the account isn't taxed, and distributions are tax-free if spent on qualified education expenses aying college expenses. You may be able to take a credit for some of your child's tuition expenses. There are also tax-advantaged ways of getting your child's college expenses paid by others.

Tuition tax credits
You can take an American Opportunity tax credit (AOTC) of up to $2,500 per student for the first four years of college-a 100% credit for the first $2,000 in tuition, fees, and books, 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 and fees.

The AOTC is 40% refundable. That means that you can get a refund if the amount of the credit is greater than your tax liability. For example, someone who has at least $4,000 in qualified expenses and who would thus qualify for the maximum credit of $2,500, but who has no tax liability to offset that credit against, would qualify for a $1,000 (40% of $2,500) refund from the government.

Both credits are phased out for higher-income taxpayers for couples with income between $160,000 and $180,000, and for singles with income between $80,000 and $90,000.

Only one credit can be claimed for the same student in any given year. However, a taxpayer is allowed to claim an AOTC or a Lifetime Learning credit for a tax year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a Coverdell education savings account for the same student, as long as the distribution isn't used for the same educational expenses for which a credit was claimed.

Payee statement (Form 1098-T) from the educational institution required before tuition credits or qualified tuition deduction can be claimed

To claim the education tax credits, a taxpayer must receive a Form 1098-T payee statement from the educational institution. For purposes of this requirement, if a person the taxpayer claims as a dependent receives the Form 1098-T, the statement is treated as received by the taxpayer.

Withdrawals from retirement plan accounts

IRAs and certain qualified retirement plans represent the largest cash resource of many taxpayers. You can pull money out of 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 tax under the usual rules for IRA distributions.

Not all of the above breaks may be used in the same year, and use of some of them reduces the amounts that qualify for other breaks. So, it takes planning to determine which should be used in any given situation. If you would like to discuss one or more of the above planning or payment possibilities, or any other alternatives, in more detail, please call.

Yours truly,

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