

SYLLABUS:

An Informal Memo for Clients and Friends of Lord, Bissell & Brook

PLANNING FOR YOUR CHILDREN'S COLLEGE EDUCATION

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College costs are rising each year at a rate that outpaces inflation by at least two percent. Tuitions have increased an average of 9% a year nationwide since 1980. An undergraduate education at a private school that commences in the year 2005 is predicted to cost approximately \$120,000. Parents with young and newborn children must plan today for the funding of their children's education. The following is a summary of the techniques available to successfully plan for this funding. The choice of which techniques to use should be fully discussed with and analyzed by one's attorney or financial adviser.

1. Income Shifting

a. A Child as a Separate Taxpayer

Immediately prior to the Tax Reform Act of 1986, the maximum marginal tax rate for individuals was fifty percent. Income shifting devices were often used to allow for the accumulation of funds at lower tax rates to provide for a child's college and graduate school education. Parents who were in a high marginal tax bracket could transfer funds to a custodian

account for their minor children and allow the funds to accumulate at substantially lower tax rates (i.e., at the rates of their children). Parents who did not want to dispose of the property permanently but who still desired income to grow at lower tax rates often entered into so-called "Clifford trusts" and "spousal remainder trusts." Under these approaches, a parent would establish a trust for the benefit of their children to last for a certain number of years. During the term of the trust, income would be distributed to their children and taxed at the children's rates. At the termination of the trust, the trust principal would return to the parent or his or her spouse.

The provisions of the Tax Reform Act of 1986 substantially impair the effectiveness of income shifting strategies. In particular, the Act provides that the amount of "unearned" income (in excess of \$1,000) of a child who is not at least 14 years of age is now taxed at the higher of the child's own rate or the rate that would be applicable if the parents had earned that income. This has become known as the "kiddie tax."

Despite the provisions of the Tax Reform Act of 1986, parents can still transfer property to their minor children (via a custodian account) and allow part of the income earned on such property to be taxed at a lower tax rate. The first \$500 of income generated by property held for or owned by a child will be allowed as a standard deduction for the child and will not be subject to tax. The next \$500 of "unearned" income will be taxed at the child's rate, which generally will be 15 percent (unless the child is earning enough to place him or her in the 28 percent tax bracket). Any "unearned" income in excess of \$1,000 invokes the kiddie tax, which will subject that excess to tax at the higher of the child's rate or the parents' highest marginal rate. But the kiddie tax only applies to children under the age of 14 years. As discussed in more detail below, an effective college savings strategy will be to transfer property to a minor (under the age of 14) which has substantial appreciation potential but which will not generate large amounts of income, and thereafter to have the child sell the property and realize the gain after attaining the age of 14 years.

Custodian accounts generally cost nothing to establish and can be administered by a parent, as custodian. Property in a custodian account may only be distributed to or for the benefit of the child and any undistributed property must be paid to the child upon the child reaching a certain age (in Illinois, either age 18 or 21, depending on

how the property was initially transferred).

b. The Trust as a Separate Taxpayer.

An alternative to using a child as a separate taxpayer to shift income is to use a trust as a separate taxpayer. For example, trusts could be set up for the benefit of each minor child. Generally, any income earned and accumulated is taxed at trust rates, which means the first \$5,200 of income will be taxed at the 15 percent rate. This could result in a yearly savings from tax of \$936 (that is, the difference between the 33 percent rate and the 15 percent rate, 18 percent, times \$5,200). However, one must consider the irrevocable nature of and administrative costs associated with a trust (costs will consist primarily of drafting the trust agreement and filing yearly tax returns).

c. Funding Trusts and Custodian Accounts

i. Generally. In establishing a trust or custodian account, special attention should be placed on its funding. One concept is to keep income earned at minimal levels prior to the child attaining the age of 14 years (in order to avoid the kiddie tax on amounts in excess of \$1,000), to allow the property to appreciate, and to have the child or trust sell the property after he or she turns age 14 (at which time the kiddie tax will no longer apply and the gain will be taxed at the child's rates, which presumably will be

lower) in order to defray the costs of a college education. Funding may also be with assets with nontaxable yields, for example, Series EE bonds (see below) and tax exempt bonds. The terms of a trust should allow for a shift in investments when a child attains age 14, at which point the so-called "kiddie tax" will no longer be applicable and all income (not just "unearned" income less than \$1,000) will be taxed at the child's rates as a separate taxpayer. Any gain which is then recognized by the sale of appreciated investments will be taxed at the child's rates, which presumably will be lower than the parents' highest marginal rate.*/ The gain can then be used to fund a college education.

ii. Series EE Bonds.

Investments such as Series EE bonds allow a child's income to be deferred until either the bonds are redeemed or the child elects to recognize the income. Series EE bonds are sold at one-half their face value and currently mature in twelve years. The bonds earn income each year at a guaranteed minimum rate. Although this rate cannot decrease (if the bonds are held for a certain minimum period of time, generally five years), it may increase over the life of the bonds. The varying interest rates make it impossible to know exactly how much the bonds will be worth at maturity. The income earned on the bonds is not realized until the bonds are redeemed.

If a decision is made to redeem Series EE bonds, selected bonds can be redeemed each year,

and the amount of interest income the child must recognize can be controlled. Alternatively, the bonds can be retained, and the child can elect to recognize taxable income on the bonds in any year after he or she reaches the age of 14.

For certain families, there will be a permanent avoidance of federal income tax on the accrued interest when the Series EE bonds are redeemed to pay college tuition. The bonds must have been issued after January 1, 1990 and must be purchased in the parents' name. For parents with adjusted gross income in excess of \$90,000, this exclusion is not available. Thus, parents should consider deferring compensation to a year other than the year of redemption if such deferral will allow the parents' adjusted gross income to be less than \$90,000. Other technical limitations apply.

iii. Growth Stock. Growth stock or shares in a growth stock mutual fund are worthy of consideration. An investment portfolio placing emphasis on long term capital growth may be appropriate if there is some assurance that investments will be held until the year the child attains age 14. Appreciation on the stock will not be recognized until the stock is sold, which could be after the child is age 14 and can use his or her own tax rates for unearned income.

iv. Land. Vacant land that is expected to appreciate in value allows a child to hold a nontaxable investment while under the age of 14. Once a child turns age 14, the

property can be sold and the gain taxed at the child's marginal rates.

v. Tangibles. Although potentially riskier, investments such as coins and precious metals, antiques, art and limited partnership interests on behalf of a child under the age of 14 could provide appreciation without current income tax. Because investments in tangible items generate no income, the entire return on such investment may be afforded when the investment is sold after the child is age 14.

vi. Insurance Owned by Child. If the child or a trust for his or her benefit owns a cash value life insurance policy on the life of the parent, loans may be made against the policy and the loan proceeds invested (after the child attains age 14, to avoid the kiddie tax) to yield income. The earnings on the investment portion of the insurance policy will accumulate without current tax.

2. Closely Held Stock and Family Owned Businesses

If the parent is an owner of a closely held corporation, one possibility is a gift of stock which, presumably, has high appreciation potential. Further, a parent may employ the child in the parent's business to provide a source of earned income (to be used for college education). The "kiddie tax" applies only to "unearned" income of a child. As to "earned" income, the child will enjoy the benefit of the standard deduction (\$3,100 in

1989) against tax and will be taxed at the child's rate, not the parents' rate.

3. Gifts from Grandparents

If the grandparents of a child for whom an educational fund is sought are wealthy, consideration should be given to their supplying an educational fund in planning the grandparents' estate. If this is not done and the grandparents leave all of their property to their children, the children should consider disclaiming all or part of their inheritance (assuming the disclaimed property would automatically pass to the grandchildren). A sum of \$100,000, for example, placed in a custodian account for the benefit of the grandchildren will grow more rapidly (if the grandchildren are 14 years or older the kiddie tax is no longer applicable) than if placed in the hands of children who are presumably in higher federal and state income tax brackets. Thus, the parents will in the end have less of a financial burden than if they had been given the \$100,000 and used it for the child's education.

4. Mortgage and Loans

A parent with a substantial equity in a primary or secondary home may consider mortgaging the home and using the proceeds to pay the child's college costs. The interest paid on up to \$100,000 of home equity indebtedness will be deductible despite the fact that the proceeds are being used for tuition and other college expenses.

Parents may wish to consider obtaining loans in other ways, too. For example, one not-for-profit student aid program currently offers loans of up to \$15,000 annually, at a variable interest rate, with eligibility based on credit-worthiness, not need.

5. Annuity

An older parent or grandparent may purchase a single premium deferred annuity with payouts geared to the child's entry to college.

6. Educational Investment Vehicles

a. Contracts With Colleges

For payment of a relatively small fraction of the projected costs of four years of college up to eighteen years in the future, some educational institutions offer contracts which provide tuition for four years. Contract holders whose children do not attend that college will receive a refund that has been agreed to in the original contract (usually the premiums plus interest calculated at low rates).

b. College Certificates of Deposit

One new investment is the College Savings Bank's CDs (the College Savings Bank is located in Princeton, New Jersey), which are designed to keep pace with the inflation experienced by five hundred colleges and universities. One unit of this CD is guaranteed, at maturity, to cover the average

expenses of those five hundred colleges for one year. The payoff from this type of investment will depend, in part, on the college inflation rate and on the lost opportunity costs of investing in other vehicles which would have yielded a higher return.

7. State of Illinois General Obligation College Savings Bonds

These bonds are zero coupon instruments which pay no current interest. Interest accrues from the date of issuance and compounds semi-annually on February 1 and August 1 of each year, until maturity. Principal and interest on the bonds are payable at maturity. The bonds are not callable. The bonds are priced at a substantial discount. For example, assuming an 8% yield to maturity with a maturity date of 2007, an initial investment of \$2,165 (in 1988) would result in the receipt of \$10,000 at maturity.

These bonds are exempt from federal income taxes for individuals. The bonds are also not subject to the alternative federal minimum income tax for individuals. Further, unlike virtually all other municipal securities issued by the State of Illinois, its agencies and its cities and towns, the State of Illinois General Obligation College Savings Bonds are exempt from the Illinois state income tax.

Importantly, although the bonds are referred to as College Savings Bonds, the purchase of these bonds is not limited by either amount or purpose. Any investor

seeking a long term tax exempt zero coupon investment opportunity is eligible to purchase the bonds. The bonds do, however, include a grant program incentive for investors applying monies paid at maturity for students registered at institutions of higher education located in Illinois. The grant awards constitute financial incentives that are subject to the annual appropriations by the General Assembly in the year in which the grant awards will be made. The awards are not guaranteed by the State of Illinois.

In order to be eligible for the grant awards, the bonds must have been owned by the bondholder for at least a 12 month period preceding the date of maturity. The grants will be paid to the student's institution of higher education and may be used only for the payment of educational expenses. Subject to annual appropriations (and other various criteria), eligible students will receive grants for any current school year in certain amounts per \$5,000 "Compound Accreted Value" at maturity of these bonds. For example, a grant bond maturing in 2000 at \$5,000 could entitle the recipient to a grant of \$240 to be used to pay educational expenses.

*/ Parents may wonder why they cannot hold onto appreciable property, rather than using it to fund a custodian account or trust, and then transfer the property to their child upon the child attaining age 14 years. One answer is that

there may be undesirable gift tax consequences with that approach. Under the Internal Revenue Code, each individual is allowed to transfer \$10,000 (\$20,000 if his or her spouse consents) per year per donee without incurring gift tax liability. However, any amount in excess of \$10,000 (or \$20,000, if the spouse consents) will subject the parents to gift tax. For example, if property transferred to a child when the child is age 1 (say in year one) is less than \$20,000, the transfer would generate no gift tax. If in year 14 (when the child is age 14) the same property is worth \$100,000, it could not then be transferred to the child without generating gift tax consequences. Therefore, the transfer to the child in year 1 is preferable from a gift tax perspective. Unless the circumstances dictate otherwise, parents should not transfer more than \$20,000 of appreciable property to a custodian account or trust for a child in any one year.

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