NORTHERN TRUST

FUNDING EDUCATIONAL OPPORTUNITIES: MAKING DREAMS A REALITY

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Planning for the education of a child or grandchild is an important goal for many families. Whether you are a new parent starting to think about your child's future, a grandparent who wants to give the gift of learning, or an individual seeking funding solutions for a child heading to college within the year, finding the right savings plan can be complex.

Before addressing how to save for education, a family should first identify its goals. Time horizon, type of education, and family circumstances will define the best approach. Saving for pre-school requires a different approach than saving for college or graduate school.

In this paper, we highlight various savings strategies to help you choose the best one for your particular circumstances, time horizons, and education costs. To plan for your particular circumstances it is advisable to consult with your financial, legal and tax advisors.

TAX CONSIDERATIONS

If you give money to a beneficiary, you need to think about federal and state gift and generation-skipping transfer (GST) tax consequences. These taxes can apply even if the beneficiary spends the money on education. But, the annual federal gift tax exclusion for 2018 allows a family to give a single beneficiary $15,000 ($30,000 per married couple) per year without incurring any gift or GST tax liability. The beneficiary can use this money to cover education or non-education expenses. Direct tuition payments to elementary, secondary, post-secondary or other formal schools also are not subject to gift tax. The exclusion for direct tuition payments is available regardless of the relationship between the donor and the student, but the exclusion does not extend to books or room and board.

State and federal governments also offer education income tax credits. At the federal level, there are two tax credits: the Lifetime Learning Credit and the American Opportunity Tax Credit. Taxpayers can claim one credit or the other, but not both.

FEDERAL EDUCATION INCOME TAX CREDITS			
	Amount of Credit	**Type of Education**	**Income Limitations***
Lifetime Learning Credit	$2,000 per tax return.	All years of post-secondary education and for courses to acquire or improve job skill (including non-degree programs).	$134,000 if married filing jointly; $67,000 for single filers.
American Opportunity Tax Credit	$2,500 per student per year.	Four-year college.	$180,000 if married filing jointly; $90,000 for single filers.

**Income numbers refer to "modified adjusted gross income," which often is the same as "adjusted gross income" or "AGI."*

ACTION: Consider whether a student should file an independent tax return in order to claim an education tax credit. The education tax credit is available to the student, but only if he is not a dependent on someone else's return. Under 2017 tax law, parents generally claimed students as dependents. Under 2018 tax law, the personal exemption has been suspended, so there may be less incentive to claim students as dependents and more incentive for students to file independently.

EXAMPLE

2017 Tax Law

- Parents have modified adjusted gross income over $180,000 and therefore are ineligible for education tax credits.
- Parents decide to claim their son, a college student, as a dependent on their return because the personal exemption is $4,050.
- Son cannot claim the $2,500 education tax credit because he is a dependent. But, the family is better off because the $4,050 personal exemption was more valuable than the $2,500 forgone education credit.

2018 Tax Law

- Parents have modified adjusted gross income over $180,000 and therefore are ineligible for education tax credits.
- Parents do not claim their son, a college student, as a dependent on their return because there is no personal exemption through 2025.
- Son can claim the $2,500 education tax credit because he is not a dependent. The family is better off because the $2,500 education tax credit is more valuable than a $0 personal exemption.

LONG-TERM PLANNING OPTIONS

According to the College Board, the average cost of tuition at a private, four-year institution for the 2017-2018 school year is $34,740. If you factor in room and board, books, and other expenses, this amount can balloon to well over $50,000 annually.

Education savings vehicles include 529 plans, Uniform Transfers to Minors Accounts (UTMAs), and 2503(c) minor's trusts.

Coverdell education savings accounts are not commonly used because the annual contribution limits are very low. Uniform Gifts to Minors Accounts (UGMAs) largely have been replaced by UTMAs due to changes in state law.

529 PLANS

A 529 plan, also known as a qualified tuition plan, is a popular, tax advantaged way to save for education. Plans are state-sponsored and are authorized by Section 529 of the Internal Revenue Code.

Why choose a 529 plan?

- ***Tax-free growth and distributions:*** Funds inside a 529 plan are not taxed until distribution. If distributions are used towards K-12 tuition or college, vocational school, or graduate school expenses (including tuition, fees, books, supplies, and room and board), then distributions are not subject to federal income tax.
- ***Gift tax savings:*** You may contribute up to five years' worth of your annual exclusion amount to a 529 plan in a single tax year. For example, Mom and Dad could contribute $150,000 to their daughter's 529 plan in 2018 ($15,000 annually from Mom and $15,000 annually from Dad, multiplied times five years). This is known as "frontloading."

- ***Estate tax savings:*** A 529 plan generally is not included in a parent's federal taxable estate, even though the parent owns and controls the asset. This can result in federal estate tax savings.
- ***State income tax benefits:*** Some states grant a modest state income tax deduction for residents who contribute to their in-state 529 plan.
- ***International portability:*** Many schools in foreign countries accept funds from 529 plans. In the Federal School Code Search, use "FC" for "Foreign Country" and you will see a diverse set of schools across the world.

Who can fund a 529 plan?

529 plans are available to all taxpayers, regardless of income.

How much can I contribute to a 529 plan?

There are limits on how much a person can contribute to an account. While it varies by state, most states accept contributions until the plan balance reaches $250,000 per beneficiary. This limit can be as high as $500,000 in some states. If the contribution limit is of concern, consider opening 529 plans in multiple states to accumulate higher account balances. But, do not overfund a 529 plan because your options for left-over fund balances are limited.

Avoid overfunding a 529 plan.

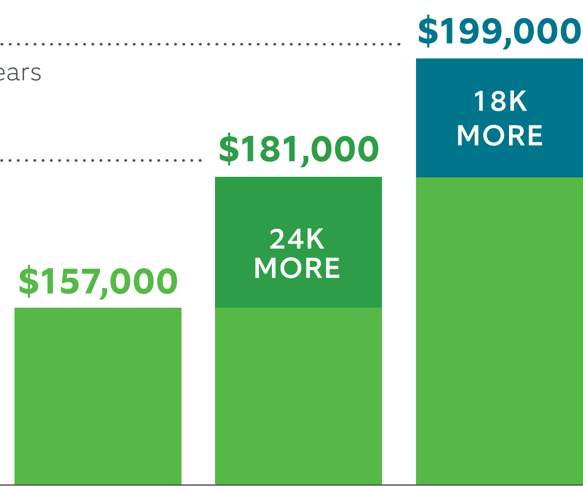
529 PLAN ILLUSTRATION

A 529 plan allows your savings to grow tax-free, and distributions used towards qualifying educational expenses are not subject to federal income tax.

Total saved with a Lump Sum “Frontloaded” Contribution $199,000
$75,000 ($15,000 x 5) single contribution + growth over 20 years

Total saved with a 529 Plan $181,000
$15,000 per year for 5 years + growth over 20 years

Total saved with a Taxable Account $157,000
$15,000 per year for 5 years + growth over 20 years minus taxes



The example above shows a growth rate of 5% with a 25% turnover rate and 20% capital gains tax for illustrative purposes. If the illustrative portfolio would have been an actual portfolio, it would have been subject to market and economic conditions, fees, and costs that could have materially impacted performance and the results illustrated above.

What's new about 529 plans?

The 2017 Tax Cuts and Jobs Act (Tax Act) expanded the 529 plan rules to include qualified elementary and secondary education tuition expense. There is, however, a $10,000 annual cap on distributions for K-12 education. Distributions in excess of $10,000 are subject to federal and state income tax on the earnings portion of the withdrawal, plus an additional 10% federal penalty.

Under the new federal tax law, 529 plans can be used to pay for K-12 tuition — but state limits may apply.

CAUTION: The change made to 529 college savings plans under the Tax Act is just one side of the equation — the federal side. The other side of the equation is the state side. Since 529 plans are state-sponsored programs, the states — and their lawmakers — determine the rules and limitations regarding their own state's program. The definition of "qualified higher education expenses" as modified under the Tax Act to include K-12 tuition must also be adopted at the state level. This will involve changing how "qualified higher education expenses" and "eligible educational institutions" are defined for state law purposes. Therefore, exercise caution when using these programs for elementary and secondary education expenses, particularly if your state's program allows you to take a state income tax deduction for certain amounts contributed to its program.

ABLE (ACHIEVING A BETTER LIFE EXPERIENCE) ACCOUNTS

Like 529 plans, ABLE accounts are established and maintained at the state level. They allow people with disabilities to save for education while still qualifying for government benefits.

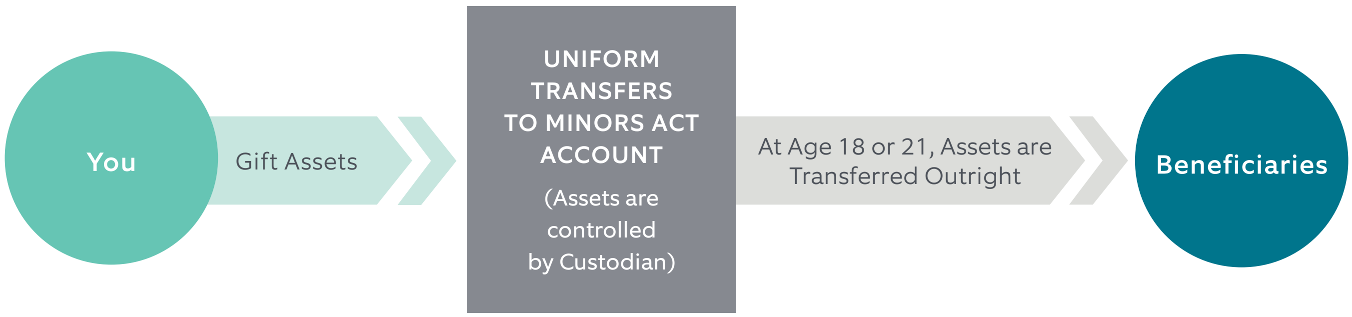
What's new about ABLE accounts?

Under the Tax Act, ABLE account owners who work and earn income can contribute additional amounts to their ABLE accounts. Generally, ABLE contributions from all sources are capped at the annual gift tax exclusion amount ($15,000 for 2018). But, through 2025, ABLE account beneficiaries with compensation income can contribute the lesser of (a) the beneficiary's compensation for the tax year, or (b) the federal poverty line amount for a one-person household in the prior year ($12,060 for 2017), even if the beneficiary or others have contributed the $15,000. ABLE accounts are administered by the states, so contribution rules could vary from state to state.

The Tax Act also allows some ABLE account beneficiaries to claim the federal "savers credit" for their ABLE account contributions. The beneficiary must meet strict income limits, and the maximum tax credit is $1,000. The tax credit does not apply to contributions after December 31, 2025.

UNIFORM TRANSFERS TO MINORS ACT (UTMA) ACCOUNTS

UTMAs generally allow adults to transfer cash or property to children with the comfort of knowing that an adult custodian will manage the account. Specific rules vary by state.



Why choose an UTMA account?

- ***Ease of administration:*** An UTMA account can be opened quickly with basic paperwork.
- ***Estate tax planning:*** UTMA assets are not included in the donor's estate unless the donor is the custodian of the account. This means that once a donor uses his annual and lifetime gift tax exclusion to transfer assets to an UTMA, the initial value and subsequent appreciation likely will not be included in his estate.
- ***Flexibility:*** UTMA funds do not have to be used for education.

CAUTION: The child legally owns the assets in the UTMA account at age 18, 21, or 25, depending on the state. If you want gifted assets to be earmarked exclusively for education, an UTMA likely is not the best choice.

UTMAs are managed by an adult custodian for the benefit of a child.

2503(C) MINOR'S TRUSTS

2503(c) minor's trusts allow parents, grandparents, and other donors to make gifts of a present interest to a beneficiary. The gift becomes fully distributable when the beneficiary reaches the age of 21.

Why choose a minor's trust?

- *Gift tax savings:* Donors may choose to take advantage of the annual gift tax exclusion ($15,000 in 2018) to minimize or eliminate gift tax liability on contributions to minor's trusts. If a 2503(c) trust continues past the beneficiary's 21st birthday, the beneficiary should be given a right to withdraw assets from the trust for a designated timeframe, beginning at the age of 21. When establishing a 2503(c) trust, donors should consult with their advisors about potential generation-skipping transfer tax implications.
- *Broad definition of education:* The grantor of a 2503(c) trust may delineate a more expansive definition of education in the trust document, allowing for payments for private schools and other specific fields of study apart from traditional academia. Broad definitions are in fact required because the trust's distribution cannot be limited only to education.

SHORT-TERM PLANNING OPTIONS

Individual retirement account (IRA) funds can be used to pay for education, and can be a good option if the student is starting school soon. However, if an IRA withdrawal will jeopardize your retirement and future financial security, consider whether student loans and financial aid offer an alternate path.

Retirement accounts can be used for education funding, but may not be the best option.

For both Roth and traditional IRAs, there is an early withdrawal penalty that is equal to 10% of the total amount withdrawn. An early withdrawal is any withdrawal before age 59½, so, if you are over age 59½, the 10% penalty tax will not apply if you withdraw funds to pay for education. There also is an education exception to the 10% penalty if an early withdrawal is used to pay for qualifying post-secondary education expenses, such as college or graduate school tuition. In order to qualify for penalty relief, education payments must be made for the IRA owner, the owner's spouse, or any child or grandchild of the IRA owner or spouse. If distributions exceed qualified education expenses, the earnings portion of the excess is subject to the 10% penalty. The definition of qualified higher education expenses includes tuition, fees, books, supplies, required educational equipment, and room and board for students who attend at least half-time.

CAUTION: Although an IRA education distribution may avoid the 10% penalty, regular income tax rates apply to traditional (but not Roth) IRA distributions.

LONG-TERM PLANNING OPTIONS

	529 Plan	ABLE Account	UTMA	2503(C) Minors Trust	Traditional or Roth IRA
Investment Contribution Limits	Established on a plan-by-plan basis; some plan account balance limits may be as high as $500,000.	The annual gift tax exclusion amount ($15,000 in 2018). Through 2025, ABLE account beneficiaries with compensation income can contribute the lesser of (a) the beneficiary's compensation for the tax year, or (b) the federal poverty line amount for a one-person household in the prior year ($12,060 for 2017).	No limit.	No limit.	IRA contributions have annual limits depending on age and earnings. Traditional and Roth contribution limits are $5,500 for 2018 ($6,500 if age 50 or over).
Funding	Cash only.	Cash only.	Cash or property.	Cash or property.	Cash only.
Qualified Expenses	As modified under the Tax Act, this now includes K-12 tuition along with qualifying higher educational expenses, such as: books, computers and related equipment, and room and board at eligible colleges and universities. State tax treatment may vary.	Education, housing, transportation, employment training and support, and other expenses that improve health, independence, and/or quality of life.	No restrictions. May be used for purposes other than education.	Provides a broader definition of permissible educational expenses and related costs.	Post-secondary education: tuition, fees, books and, if the student is at least half-time, room and board.
Income Restrictions	No.	Only for beneficiary's excess contributions.	No.	No.	Yes.

LONG-TERM PLANNING OPTIONS (continued)

	529 Plan	ABLE Account	UTMA	2503(C) Minors Trust	Traditional or Roth IRA
Tax on Earnings	Earnings are tax-free if used for qualifying expenses. Distributions are tax-free when used for qualifying education expenses.	Earnings are tax-free if used for qualified expenses.	Kiddie tax rules apply. Earnings and gains taxed to minor; first $1,050 of unearned income is tax exempt. Unearned income over $2,100 for certain children under age 24 taxed at rates for estates and trusts.	Earnings are taxable. Grantor trust tax rules may apply.	Earnings are taxable on a traditional IRA and tax-free for qualified Roth withdrawals.
Federal Gift Tax Treatment	Contributions treated as completed gifts; may use annual gift tax exclusion. May frontload up to five years.	Contributions are treated as completed gifts; may use annual gift tax exclusion.	Transfers are treated as completed gifts; may use annual gift tax exclusion.	Transfers are treated as completed gifts; may use annual gift tax exclusion.	Transfers to students may be subject to gift tax rules. Payments directly to schools are not.
Ability to Change Beneficiary	Yes, but change will be most tax efficient if new beneficiary is a "member of the family" of the previous beneficiary, occupying the same generation as the previous beneficiary.	Yes, but change will be most tax efficient if new beneficiary is a "member of the family" of the old beneficiary and an individual who meets the disability definition.	No. Represents an irrevocable gift to the child.	Yes, but only if the trust terms allow.	No.

CONCLUSION

Working with your advisors to fully consider your funding options will help increase confidence that those you care about will be fully supported as they pursue their educations. Remember to keep careful records as expenses are paid, including receipts that substantiate the use of funds for education expenses. In the end, thoughtful education planning will help support the goals and dreams of future generations.

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