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**Advising the Affluent Client:**

**Education Planning**

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## Table of Contents

Introduction

Addressing Three Key Questions: *Developing an Effective Education Savings Strategy*

Step #1: Identify the Future Cost of Education

Capitalizing on Opportunities: *The Necessity of an Education Savings Plan*

Projecting Future Costs

Step #2: Identify an Appropriate Savings Vehicle

Private Investment Accounts

Custodial Accounts (UTMA/UGMA)

Coverdell Education Savings Accounts (ESAs)

Review Exercise

529 Plans: A Very Attractive Alternative

Basic Rules Governing 529 Plans

Review Exercise

Prepaid Tuition Plans: A Contract for the Future

Typical Provisions of Prepaid Tuition Plans

529 Savings Plans: For Those Who Want Greater Investment Flexibility

Review Exercise

Tax Advantages of 529 Plans

Capitalizing on Opportunities: *Selecting the Appropriate Education Savings Vehicle*

Common Client Questions About 529 Accounts

Common Client Questions About Beneficiaries

Step #3: Educate Clients on Potential Tax Credits

Review Exercise

Conclusion

## Introduction

One of the more significant financial liabilities facing individuals with children is saving for college. Nearly every parent, and in some cases grandparents, cite saving for college as a major financial goal – and rightfully so. Recent studies show that in-state tuition, fees, room and board at public universities average $19,548\* per year. Worse still are the figures for private education, where tuition, fees, room and board average over $43,921\* per year. It’s a wonder that doctors do not greet new parents with, “Congratulations, you’ve just given birth to a beautiful baby and a substantial education liability!”

While many individuals have some understanding of the potential future costs of educating their children, very few understand the various savings options available to them, and fewer still have actually developed a clear and rational education savings strategy. In fact, a recent Harris College Financial Preparedness Poll found that 75% of investors lack basic knowledge of 529 Plans. This one study alone highlights the tremendous opportunity for financial services professionals to work with clients to help them define effective strategies for funding future education expenses.

This course is specifically designed to equip you with the knowledge you need to engage clients in more effective discussions about education savings alternatives and to help them define an effective strategy for them given their unique circumstances.

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| Objectives  At the conclusion of this course, you will:   * Have an understanding of the various savings alternatives available for education. * Be familiar with strengths and weaknesses of each alternative enabling you to better identify and communicate appropriate solutions to clients. * Be equipped with answers to common client questions about education savings alternatives. * Be able to educate clients on potential tax credits available to them |

## *\*"Average Estimated undergraduate Budgets, 2015-16" at http://www.trends.collegeboard.org* Addressing Three Key Questions: Developing an Effective Education Savings Strategy

Saving for education expenses, whether private elementary and secondary school expenses and/or college expenses, is for many individuals one of the most significant issues in their overall financial plan. Certainly there are a myriad of questions that individuals must consider in developing an effective savings strategy:

* Where will they go to school?
* How much will it cost?
* What's the best way to invest?

Addressing Three Key Questions

However daunting this task may seem, focusing on three key steps will simplify the process and enable you to help your clients develop an effective strategy that reflects their unique circumstances:

**1. Identify the future cost of education**

**2. Identify an appropriate savings vehicle**

**3. Educate clients on potential tax credits**

This course will address each of these key steps, equipping you with the knowledge you need to effectively lead individuals through the education planning process.

## Step #1: Identify the Future Cost of Education

Clearly, the first issue that individuals must address is defining how much money must be accumulated to meet future educational expenses. For most individuals, this means understanding how much money will be needed when their children go to college.

The best place to begin is with an examination of current costs. The following table illustrates the average annual costs for higher education:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **2015- 2016 Average College Costs\*** | | | | | |
| **College Type** | **Tuition and Fees** | **Room and Board** | **Books and Supplies** | **Personal & Transportation Expenses** | **Total Costs** |
| Four Year In-State Public | $9,410 | $10,138 | $1,298 | $3,215 | $24,061 |
| Four Year Private | $32,405 | $11,516 | $1,249 | $2,661 | $47,831 |

This table clearly illustrates that saving for future education expenses is not a matter to be taken lightly.

*From "Average Estimated undergraduate Budgets, 2015-16" at http://www.trends.collegeboard.org*

## Capitalizing on Opportunities: The Necessity of an Education Savings Plan

The rising cost of education makes it increasingly important for affluent clients to have a clearly defined savings strategy. In fact, having a structured education savings plan should be considered a necessity for any client faced with this future liability. However, despite the fact that the relevance of having a plan is intuitively obvious, many affluent clients have not taken the time to address this issue.

The challenge for advisors is how to translate the fact that few affluent clients have an effective education savings strategy into an opportunity to build a relationship. Following are effective questions that will enable you to identify this need and instill a sense of urgency to address it.

Description: DocumentationIcon_32px**Click the icon to view some effective questions.**

|  |
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| **Effective Questions**   * How did your current advisor help you establish a well-structured education savings plan? * How did they work with you to ensure your plan will enable your children to choose the school of their choice? * How did they help you define how much you need to save each year to meet your education goals? * How have they structured your portfolio to ensure you meet your education savings goal? |

The pages that follow outline how you can quantify the amount a family will need to save to fund future education expenses, creating the foundation for an effective plan.

## Projecting Future Costs

Obviously, education expenses can be significant, requiring individuals to develop a clear and disciplined plan for funding this liability. To define the projected liability will require adjustments to the current costs. This can be accomplished by addressing two key questions. Answering these two questions provides the rate of growth and time horizon needed for making the necessary adjustments to current costs.

**Click the icon to learn more about each question**

|  |  |
| --- | --- |
| Description: DocumentationIcon_32px | **What is the rate of inflation for tuition expenses?** |
| **Answer:** Studies conducted by the College Board found that college tuition has increased 3% annually ***in excess of the rate of inflation***, for an average education inflation rate of 6%. Extrapolating this trend forward, it will cost over $300,000 to $600,000 to send a child born today to a private college 18 years from now. | |

|  |  |
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| Description: DocumentationIcon_32px | **When will my child be enrolling in college?** |
| **Answer:** By subtracting the current age of each child from the estimated initial enrollment age, you can determine the number of years a family has to save. Most individuals begin attending college around the age of 18. | |

## Step #2: Identify an Appropriate Savings Vehicle

The next step is to identify the type of savings vehicle that is appropriate for a client. Often this question is the most complex to address, and thus becomes the focal point of the education planning process.

In order to help clients evaluate their options, advisors must be knowledgeable about each of the alternatives available.

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| The following pages provide a comprehensive overview of the primary options available:   * **Private Investment Accounts** * **Custodial Accounts (UTMAs /UGMAs)** * **Coverdell Education Savings Accounts (ESAs)** * **529 Plans** |

## Private Investment Accounts

The most obvious and most often chosen option for college savings is the traditional private investment account. Although traditional investment accounts do offer some advantages relative to other education investment vehicles, they are typically the most tax-inefficient option. Most often, individuals simply choose traditional investment accounts to fund their children’s education expenses because they have never been made aware of the alternatives.

****Advantages and Disadvantages of Private Investment Accounts****

Let’s examine some of the advantages and disadvantages of using private investment accounts to fund education expenses.

**Click each advantage and disadvantage to learn more**

Advantages

|  |
| --- |
| **Unlimited Contributions** |
| Unlike some of the other education savings vehicles we will cover, there is obviously no cap on the amount of money individuals can put into private investment accounts. Simply put, individuals are free to save and invest as much as they wish. |
| **Control of Assets** |
| Another advantage of traditional investment accounts as education savings vehicles is the fact that the account owner maintains absolute control over the use of the assets. Most other education savings vehicles have stipulations regarding how the assets in the account may be used and/or transfer control of the assets to the beneficiary at a specified time. |
| **Investment Flexibility** |
| Unlike some of the other education savings vehicles, private investment accounts offer individuals unlimited flexibility in how the assets are managed. |
| **Usage Flexibility** |
| The owner of the account may use the funds for purposes other than college (without penalty) if the need arises. |

Disadvantages

|  |
| --- |
| **Lack of Tax Benefits** |
| Private investment accounts are subject to current federal and state income taxes. Other education savings alternatives offer the donor tax-deferred growth in the account and tax-free withdrawals for qualified expenses. Generally, the significant tax advantages offered by alternative education savings vehicles outweigh the flexibility and control offered by private investment accounts, making the vehicles covered in the following pages more attractive.  However, it is possible to somewhat mitigate this disadvantage through investment in qualified U.S. Savings Bonds, where interest is tax-exempt if proceeds are used for qualified tuition and/or fees, provided the bond is purchased by an individual over age 24. However, this option provides only limited growth potential and is only available for individuals whose personal income does not exceed certain limits and is coordinated with other education benefits. |

## Custodial Accounts (UTMA /UGMA)

Accounts established under UTMA (Uniform Transfer to Minors Act), effective in the vast majority of the states and UGMA (Uniform Gift to Minors Act) effective in relatively few states, are custodial accounts used to allow minors to have assets titled in their names but managed by an adult. Upon establishing an UTMA/UGMA, the donor must appoint a custodian who will oversee the account until the minor reaches the age of majority (18 or 21, depending upon the state), at which time the individual gains full control over the assets.

From a tax perspective, income generated in UTMAs/UGMAs is taxed as unearned income to the minor child. But minors under age 19 and dependent full-time students under age 24 with “unearned income” above certain levels (adjusted for inflation) are subject to the “Kiddie Tax,” which may result in taxation at the parent’s rate. Following is an overview of the tax structure for minors who only have unearned income:

With this tax structure, UTMAs/UGMAs may be more attractive from a tax perspective than private investment accounts owned by a parent (especially for those with children 19 or older), although the level of benefit depends upon individual circumstances.

|  |  |
| --- | --- |
| **2016 KIDDIE TAX TABLE FOR MINORS** | |
| First $1,050 of income | 0% |
| Next $1,050 of income | Single Taxpayer rate |
| Income above $2,100 | The higher of the parents’ top marginal rate or the child’s tax rate (“Kiddie Tax”) |

****Advantages and Disadvantages of an UTMA/UGMA****

Let’s examine some of the advantages and disadvantages of using an UTMA/UGMA as an education savings vehicle.

**Click each advantage and disadvantage to learn more.**

Advantages

|  |
| --- |
| **Parental Control Over the Assets** |
| Assets placed into the account remain under the control of the parents until the child reaches the age of majority. |
| **Potential for Some Tax-Advantaged Growth** |
| Only unearned income in excess of $2,100 (2016, as indexed) is subject to taxation at the parents’ marginal tax rate in UGMA/UTMA accounts with beneficiaries under the age of 19 (24 if a dependent full-time student). |

Disadvantages

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| --- |
| **Loss of Control** |
| Parents maintain control over the assets in the UTMA/UGMA until the child reaches the age of majority. At that time, the child assumes full control over the assets in the account, receiving full legal authority to make both investment decisions in the account and distributions for whatever purpose desired.  This means that the child will assume control of the assets at about the time they should be in college. The child could then choose to use the money for any purpose, deciding whether to pay for college expenses or to buy a new car or to take an extended European vacation. |
| **Limits on Contributions** |
| Transfers to an UTMA/UGMA represent a completed gift and as such may be subject to the Gift Tax. Therefore, parents are limited to gifts/transfers of $14,000 per year ($28,000 jointly) for 2016 (as indexed), per child, if they wish to avoid the gift tax. However, this may no longer be an issue for most people, since each individual is given a lifetime credit against gift and estate taxes that protects the first $5,450,000 (in 2016, as indexed for inflation) of gifts or estate transfers from taxation. |
| **Inability to Change Beneficiary** |
| Unlike some of the other education savings vehicles, the parents cannot change the beneficiary. |
| **Inclusion of Donor’s Estate** |
| If the donor and custodian are the same person, the IRS says that this is sufficient control over the assets for the assets to be included in the custodian’s estate. However, this may no longer be an issue for most people, since each individual is given a lifetime credit against gift and estate taxs that protects the first $5,450,000 (in 2016, as indexed for inflation) of gifts or estate transfers from taxation. |

## Coverdell Education Savings Accounts (ESAs)

The Coverdell Education Savings Account (ESA) is an education savings vehicle that is in many ways similar to a Traditional IRA, allowing individuals to set aside up to $2,000 per year tax deferred in an account earmarked for education.

Advantages and Disadvantages of ESAs

The potential advantages and disadvantages of ESAs are listed below.

**Click each advantage and disadvantage to learn more.**

Advantages

|  |
| --- |
| **Tax-Deferred Investment Earnings** |
| Income and capital appreciation generated by the investments in a Coverdell ESA are tax-deferred while in the plan and tax-free when used for qualifying educational expenses. As a result, the assets in the account will grow more than if invested in a comparable taxable account. However, nonqualified distributions will incur income tax at ordinary income tax rates; Capital gains rates are not available. |
| **Tax-Free Distributions for Qualified Education Expenses** |
| Qualified distributions from a Coverdell ESA are not subject to income tax. Qualified distributions include distributions made to pay educational expenses for:   * Primary education * Secondary education * Higher education   If there is a balance in the Coverdell ESA at the time the beneficiary reaches age 30, it must be distributed within 30 days. |
| **Self-Directed Investments** |
| Just as in an IRA, Coverdell ESAs allow individuals to self-direct the investments in the account. |
| **Ability to Change Beneficiaries** |
| Generally it is possible to change beneficiaries as long as, at the transfer date, the new beneficiary is under age 30 and a member of the same family. |

Disadvantages

|  |
| --- |
| **Limits on Participation** |
| In 2016, eligibility is phased out for single filers with Adjusted Gross Income (AGI) of $95,000 - $110,000 or, for Joint Filers, $190,000 - $220,000.  These limits mean that many high-income earners cannot capitalize on the tax advantages of this type of plan. |
| **Contribution Limits** |
| Another disadvantage is the relatively low annual contribution limit of $2,000 per child per year. For many, $2,000 per year is simply not enough to adequately fund the enormous future costs of a college education as described earlier in this course. |
| **Required Distributions at Age 30** |
| If there is a balance in the Coverdell ESA at the time the beneficiary reaches age 30, generally it must be distributed to the beneficiary within 30 days. Income tax and a penalty will result.  However, instead of taking a taxable distribution, it may be possible to either change the beneficiary of the existing account (see “Advantages” above) or roll over the remaining funds into another Coverdell ESA for the new beneficiary on an income tax-free basis.  Tax-free rollovers require the following:   * New beneficiary must be under age 30 * New beneficiary must be part of the same family as the old beneficiary * The rollover must be completed within 60 days of the distribution |

**Special Note about Coverdell Plans**

Tax-free withdrawals from Coverdell ESA plans do not qualify for the American Opportunity Tax Credit or the Lifetime Learning Credit.

## Review Exercise

**Answer the following questions to review the preceding material**

1. **One advantage of a Coverdell ESA over a UTMA/UGMA is:**

* Coverdell ESAs offer higher annual contribution limits

**Incorrect.** Try again.

* Unlike UTMA/UGMAs, assets in Coverdell ESAs can be used for elementary and secondary institution education expenses

**Incorrect.** Try again.

* **Coverdell ESAs offer parents greater control over the assets in the account because they can remain in the account until the beneficiary reaches age 30**

**Correct.**

* Participation in Coverdell ESAs are not subject to phase outs based on parents’ AGI

**Incorrect.** Try again.

1. **According to the College Board, inflation of college costs is typically in the \_\_\_\_\_\_ range.**

* 3%

**Incorrect.** Try again.

* 5%

**Incorrect.** Try again.

* **6%**

**Correct.**

* 8%

**Incorrect.** Try again.

1. **Which of the following is the most significant drawback to using private investment accounts to fund educational expenses?**

* Lack of control over investments

**Incorrect.** Try again.

* **Lack of tax advantages**

**Correct.**

* Limits on contributions

**Incorrect.** Try again.

* None of the above

**Incorrect.** Try again.

1. **Which of the following is true of a Coverdell ESA?**

**A. Contributions are limited to $2,000 annually**

**B. Investments grow tax-deferred**

**C. Qualified withdrawals from the account are tax-free**

* A. only

**Incorrect.** Try again.

* B. only

**Incorrect.** Try again.

* C. only

**Incorrect.** Try again.

* A. and B. only

**Incorrect**. Try again.

* **A.,B., and C.**

**Correct.**

1. **John and Mary Jones file married filing jointly and expect to report an adjusted gross income of $150,000. They set up an UGMA for their 8-year-old son, who has no other source of income. At what rate will all income earned in the account over $2,100 (2016, as indexed) be taxed?**

* 0%; Income generated in a UGMA is tax-deferred

**Incorrect.** Try again.

* Income over $2,100 will be taxed at the child’s marginal tax rate

**Incorrect.** Try again.

* **Income over $2,100 will be taxed at the parent’s highest marginal rate**

**Correct.**

* Income over $2,100 will be taxed at 39.6%

**Incorrect.** Try again.

## 529 Plans: A Very Attractive Alternative

Beginning around 1990, states started developing a new type of plan designed to encourage savings for college expenses. Subsequently, in 1996, legislation was passed giving rise to what has become known as 529 Plans, referring to Internal Revenue Code Section 529, which allows these plans.

Simply stated, 529 Plans provide individuals a tax-advantaged option for saving for college. Initially, 529 Plans were not widely publicized; however, they have become an increasingly popular option in the last few years. Every state now has a 529 Plan. Against the backdrop of traditional funding alternatives, Section 529 Plans are particularly appealing, due to higher contribution limits for tax-deferred accumulation and greater donor control over the assets in the account compared to the other vehicles.

|  |  |
| --- | --- |
| **Overview** | Before we address the specifics of 529 Plans, it is important to understand the two basic types of Plans created under IRC Section 529. **Click each type to learn more.** |
| **Prepaid Tuition Plans** | Prepaid Tuition Plans are conceptually similar to defined benefit retirement plans. As the name implies, Prepaid Tuition Plans enable individuals to make contributions to the Plan that will then cover expenses for higher education in the future. |
| **Tuition Savings Plans** | 529 Savings Plans provide individuals a tax-advantaged option for saving for college. Savings Plans are conceptually similar to a defined contribution retirement plan. In a 529 Savings Plan, individuals make contributions to the plan and select from the investment options offered.  The assets can be used in the future to pay for college education expenses. The value of the assets may be more or less than the cost of education, depending upon contributions, growth and cost of the institution selected. |

## Basic Rules Governing 529 Plans

To understand how these Plans work, it is best to start with the Internal Revenue Code itself. Prior to the adoption of Section 529 in the Code in 1996, similar plans had already been created. The code section was adopted to provide the official IRS rules by which such plans are created and governed. The seven basic rules under Section 529 are listed below.

**Click each rule to learn more**

|  |
| --- |
| **1. Sponsorship limited to states and eligible private institutions** |
| A plan must be established and maintained by a state or state agency, or eligible educational institution (prepaid plans only). State programs can be either prepaid or savings plans; private educational institutions can only offer prepaid plans. |
| **2. Contributions must be made in cash** |
| This prevents individuals from avoiding the payment of capital gains taxes by contributing appreciated assets. However, note that some states permit the direct rollover of assets from one 529 Plan to another 529 Plan. A direct rollover is a transaction in which assets are transferred directly from the old 529 Plan to the new 529 Plan.  All other transfers to a 529 Plan must generally be made in cash. Assets held in UGMA/UTMA accounts, Coverdell Education Savings Accounts, or certain U.S. Savings Bonds issued after 1989 must be distributed in cash and then deposited within 60 days into the 529 Plan. The use of UGMA/UTMA funds for 529 Plan contributions is either restricted or forbidden in many states. |
| **3. Investments cannot be individually directed** |
| Contributors are not allowed to individually direct the investment of any contribution, but so far this requirement seems to have been interpreted rather loosely. While contributors have not been allowed to choose from among individual stocks and bonds or from among unlimited numbers of mutual funds, Plans are allowing contributors to allocate balances among a group of investment options established by the Plan. |
| **4. Plans must provide separate accounting for each participant** |
| The Program must establish separate accounting for each participant. This applies to both Prepaid Tuition and Savings Plans. However, in the Prepaid Tuition plans, the separate account is basically maintained to track dollars paid for contracts. |
| **5. Assets cannot be used as collateral** |
| A Program cannot allow an account to be used as security for a loan. |
| **6. Plan Must Have Reasonable Limits On Contributions** |
| There must be reasonable limits on contributions to the Program. This has been interpreted as allowing contributions in the amount of projected future education costs. Therefore, limits are set giving consideration to the cost of up to 5 years at the most expensive schools in the country, bringing current contribution limits in most plans above $300,000. If the accumulation limit is reached, no more contributions can be made. |
| **7. Penalties and Restrictions For “Non-Qualified” Withdrawals** |
| A non-qualified withdrawal is one that is not used to pay for tuition, fees, books, supplies, equipment, and room and board at an eligible educational institution. Non-qualified withdrawals are subject to a tax penalty on the earnings portion of the amounts withdrawn. Earnings are also subject to income taxation.  Prior to 2001, the requirement was that the penalty had to be for more than a “***de minimis***” amount. De minimis was interpreted to be at least 10%. The amendment to this requirement enacted in 2001 changed the penalty on earnings from ade minimis amount to a Federal 10% additional tax on the earnings portions of non-qualified withdrawals.  Payments made as a result of the death or disability of a beneficiary or as a result of the receipt of a scholarship are exempt from this additional tax. |
| **8. Plans can be used across state lines** |
| In most cases, 529 plans are no longer restricted by state lines. That means you could live in Florida, invest in a state plan in Wisconsin, and send your student to college in Nevada.  Some plans still have restrictions, though, so it’s always a good idea to check the guidelines for each plan. |

## Review Exercise

**Select the correct answer.**

1. **One advantage of a 529 Plan over a Coverdell Education IRA is:**

* Tax-deferred investment earnings

**Incorrect.** Try again.

* Funds can be used for primary and secondary education.

**Incorrect.** Try again.

* Investments can be self-directed

**Incorrect.** Try again.

* **No Adjusted Gross Income limits**

**Correct.** This allows people with high income to make tax deferred contributions that would be prohibited in a Coverdell IRA.

1. **While it is not possible to individually manage the investments, when making contributions to a Prepaid Tuition Plan it is possible to select from among the investment options provided by the Plan.**

* True

**Incorrect**. It is only possible to select from among investment options with a Tuition Savings Plan. With a Prepaid Tuition Plan, the contract is for a guaranteed benefit and the investments are totally handled by the Plan.

* **False**

**Correct.**

1. **Which of the following statements regarding 529 Plans is FALSE?**

* Plans must be sponsored by a state, state agency, or eligible educational institution.

**Incorrect.** Try again.

* Plans will typically accept either cash contributions or contributions of securities.

**Correct**. In fact they can ONLY accept cash contributions.

* Funds placed in a Plan cannot be used as security for a loan.

**Incorrect.** Try again.

* There are penalties and restrictions for "non-qualified withdrawals"

**Incorrect.** Try again.

* Maximum contribution amounts are set by the individual state sponsoring the plan.

**Incorrect.** Try again.

1. **Which of the following is probably NOT a qualified withdrawal from a 529 Plan and would therefore be subject to a 10% penalty?**

* Tuition

**Incorrect.** Try again.

* Books

**Incorrect.** Try again.

* Dormitory expense

**Incorrect**. Try again.

* Meal Plans

**Incorrect.** Try again.

* **Transportation**

**Correct.**

1. **Non-qualified withdrawals are subject to a Federal 10% tax on the full amount of the withdrawal.**

* True

**Incorrect**. The tax is only on the earnings portions of non-qualified withdrawals.

* **False**

**Correct.** The tax is only on the earnings portions of non-qualified withdrawals.

1. **The Martins are looking to start a tax-deferred college savings vehicle to supplement the 529 Savings Plan they have already established for their son. While they are not looking to contribute more than $1,500 per year, they would still like to make decisions on how the money is directed. Based on these facts, is the Coverdell ESA a viable option?**

* **Yes. The Coverdell ESA would accommodate all of the Martin’s needs.**

**Correct!**

* No. The CESA does not allow owners to self-direct the investments.

**Incorrect.** The CESA does allow self-directed investments. Try again.

* No. The fact that the Martins have a 529 Plan already established might affect their ability to make tax-deferred contributions.

**Incorrect.** The CESA is compatible with other plans. Try again.

* Yes. Even though they will only be able to contribute $1,000 per year, it would still be a viable option.

**Incorrect.** The CESA allows contributions up to $2,000. Try again.

## Prepaid Tuition Plans: A Contract for the Future

A Prepaid Tuition Plan is one in which a contract is purchased for a ***specific price***. This contract may provide a ***guarantee*** to pay tuition and fees at an accredited in-state public college or university, as stipulated by the Plan. If the student attends a private college or university, or attends an out-of-state public college or university, the plans **typically** pay the average of in-state public college tuition. The family will be responsible for the difference, if any.

The price of the contract is based upon a number of factors, including:

* The current cost of in-state public college tuition and fees.
* The age of the prospective student.
* The number of years of education to be purchased.
* The time period over which the contract will be paid (for example: lump sum versus 10 year installments).
* Actuarial assumptions regarding how much tuition and fees will increase in the future and the future return on investments.

The contract defines the specific education expenses that will be covered for the specified student. When the student begins school, the contract will pay the expenses at the level required at that time.

Description: DocumentationIcon_32px**Click the icon to view a State Prepaid Plan example.**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Example - The Smiths**  Jack and Lauren Smith have a four-month-old baby, Michael. In-state tuition and fees are currently $5,000 per year. They want to be assured that Michael will be financially able to attend college, so they have chosen to participate in the State Prepaid Plan. The following are the stipulations of the Plan:   |  |  | | --- | --- | | **Child’s current age:** | 4 months | | **Lump Sum Contribution Price:** | $20,000 | | **Benefit:** | 4 years tuition and fees at one of the accredited state universities |   In 18 years, when Michael is ready to attend college, tuition and fees are projected to grow 7 to 8% per year, giving rise to an expected future cost as high as $80,000. Regardless of the actual future cost, the Prepaid Plan will pay the tuition and fees for him for the four years stipulated in the Plan. |

It is important to understand that a Prepaid Plan is designed to pay in-state public tuition and fees that are in effect at the time the child goes to college, not a specified dollar amount. In the above example, if the tuition and fees rise to $20,000 per year by the time the child goes to college, then $20,000 will be paid. Likewise, if tuition and fees only rise to $10,000 per year, then $10,000 will be paid.

## Typical Provisions of Prepaid Tuition Plans

Although every state Prepaid Plan is somewhat unique, there are some common provisions. To gain a deeper understanding of this type of 529 Plan, let's examine some of the typical provisions more closely.

**Click each provision to learn more**

|  |
| --- |
| **Institutions Covered** |
| Most plans provide contracts for at least four years of university study, two years of community college, and a combination program of two years community college and two years of university. Other types of contracts may also be available, including those that provide for a specific number of credits or hours. |
| **Expenses Covered** |
| Plans will cover tuition and fees for the type of contract purchased. Also generally covered are books, supplies and equipment. Some Plans will even cover certain levels of room and board. |
| **Tuition Payment** |
| Plans will pay the full expenses covered under the contract purchased for in-state public schools. For attendance at private or out-of-state public schools, generally the weighted average tuition for all in-state public schools is paid. The weighted average calculation will be based on the attendance at each in-state public college.  For example, suppose there are three public schools in a state, all with the same attendance, but with differing annual tuition charges of $3,000, $4,000, and $5,000. If a student decides to go to the most expensive public school, then the plan would pay the full $5,000. But if the student chooses to attend a private college or out-of-state school, the plan will only pay $4,000, the weighted average tuition amount of the three public schools. |
| **Contract Purchase Options** |
| At the time of contract purchase, the purchaser has options regarding how payments will be made. The normal choices include:   * One lump sum contribution * Annual or monthly payments for a set period of years or until the student is expected to start school * Combination of lump sum and annual/monthly payments |
| **Plan Fees/Expenses** |
| There are fees that apply to contracts. An application fee is almost always charged. Other fees that may be levied under certain circumstances include late fees for the tardy receipt of required payments and fees if you request a change in certain contract provisions. There will also normally be a fee charged if you request the contract be canceled. |
| **Refunds** |
| Under certain circumstances, refunds from the plan may be requested. These circumstances include contract cancellation, death, disability, or the receipt of a scholarship by the student. The amount of the refund will generally be the amount the purchaser paid for the contract plus investment earnings. For contract cancellation, Federal income taxes and a 10% Federal tax penalty will apply on the earnings. |
| **Contract Changes** |
| Transfers or substitutions of beneficiaries within a family may be available for an adjustment in contract price. |
| **State Guarantees** |
| Program solvency may be guaranteed by the sponsoring state. |
| **Investments** |
| The investment managers and investment allocation are determined by the Program. The investment goal of the Plan is to ensure that financial projections and liabilities will be met. |

## 529 Savings Plans: For Those Who Want Greater Investment Flexibility

The greatest growth is taking place with Savings Plans. The 529 Savings Plan has a very simple concept behind it. An individual makes contributions to a 529 Plan account that grows tax deferred and must then choose from among the predefined investment options offered by that plan. Generally, the available investment options range from conservative to aggressive, and offer pre-determined investment mix options that will vary depending on the age of the prospective student. This last option, the pre-determined investment mix, will tend to be very aggressive for young prospective students and become increasingly conservative as they near college age. Regardless of the investment option chosen, when the beneficiary starts college, assets in the account can be withdrawn federally tax free to pay for “qualified” education expenses (tuition, books, fees, room and board). Depending on the state, state taxes may or may not be due.

To contrast Savings Plans to Prepaid Plans, let’s again use the example of the Smith’s.

Description: DocumentationIcon_32px**Click the icon to view a 529 Savings Plan example.**

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| **Example - The Smiths**  Jack and Lauren Smith decide to begin saving for their newborn son Michael’s college education. They choose to open a 529 Savings Plan, making monthly payments of $250 ($3,000 per year). From the five investment options provided, they choose the Aggressive Option that has a mix of 90% Large Cap Stocks and 10% Intermediate Term Bonds. Given historical returns, they can expect to earn about 8% on their contributions, bringing the total in 18 years to $120,000. That is considerably more than their 18-year contribution of $54,000.  **Note:** They have assumed market risk with this Plan. While they might end up with $150,000 or even more for their child’s education, they could also suffer poor investment performance. For example, if they averaged an annual return of 4%, the ending balance would be $79,000. Other factors may also affect the investment return of a 529 Savings Plan, such as sales charges, fees, and expenses that vary depending upon specific plans. |

Thus, while the ultimate objective of the Prepaid Tuition Plan and the Savings Plan is the same – to allow for the accumulation of assets that will be used in the future to pay for college expenses – the approach in each plan is quite different. As you can see from the examples given, a Prepaid Plan is a contract between the state and the contributor to pay for college expenses as stipulated by the plan. Alternatively, a Savings Plan enables the contributor greater flexibility in the amount of contributions and choice among investment options. But with Savings Plans, there is no guarantee that the assets in the Plan will be enough to cover Qualified Expenses – the assets could be more or less than what is needed, dependent upon contributions, investment opportunities, and cost of the educational institution selected.

## Review Exercise

**Review the preceding material by answering the following questions.**

1. **All of the following are factors that influence the price of a Prepaid Tuition contract EXCEPT:**

* The current cost of in-state public college tuition and fees

**Incorrect.** Try again.

* **The current cost of in-state private college tuition and fees**

**Correct**. The cost of private colleges is not taken into consideration.

* The time over which the contract will be paid

**Incorrect.** Try again.

* Actuarial assumptions regarding how much tuition and fees will increase in the future and the future return on investments

**Incorrect.** Try again.

1. **An application fee is almost always charged on Prepaid Tuition Plans and Savings Plans.**

* **True**

**Correct.**

* False

**Incorrect.**

1. **Although state-sponsored, states are prohibited from guaranteeing program solvency of Prepaid Tuition Plans.**

* True

**Incorrect.** The solvency of Prepaid Tuition Plans may be guaranteed by the state.

* **False**

**Correct.**

1. **For a 529 Prepaid Plan, if a student attends a private or out-of-state school, the plan will generally:**

* Pay the equivalent of the lowest in-state public school tuition.

**Incorrect.** Try again.

* Distribute ¼ of contributions each year the student attends a private or out-of-state school.

**Incorrect.** Try again.

* Pay the equivalent of the highest in-state public school tuition.

**Incorrect.** Try again.

* **Pay the average in-state public school tuition.**

**Correct.**

## Tax Advantages of 529 Plans

Of all the benefits offered by 529 Plans, the most significant relate to the tax advantages that these Plans offer. The following is an overview of the major tax advantages offered by 529 Plans.

**Click each advantage to learn more.**

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| **Investment Earnings are Tax-Deferred** |
| Unlike traditional taxable investment accounts, investment earnings of a 529 Plan are tax-deferred, enabling individuals to capitalize on the significant benefits of tax-deferred growth. |
| **Qualified Distributions are Non-Taxable** |
| Qualified distributions from a 529 Plan are free from Federal income taxes. Qualified distributions include tuition, fees, and books at an accredited college or university and expenses for room and board. |
| **Potential State Income Tax Deduction** |
| In some states, contributions by state residents to that state's 529 Plan(s) are state tax deductible or other tax benefits may be available. In some states, the state tax benefits are substantial.  **Note**: This benefit is not applicable in all states. You should review the provisions of your Plan(s) and you must recommend that clients see a tax advisor to see if this additional tax benefit is applicable. |
| **Estate and Gift Tax Benefits** |
| Less well known than the income tax benefits of 529 Plans are the Estate and Gift tax benefits. Contributions to 529 Plans are considered a completed gift, meaning the assets are no longer considered part of the contributor's estate. This provision enables higher net worth individuals to use 529 Plans as part of an overall strategy to reduce the size of their estate and, thus, their potential estate tax liability, while still maintaining a high degree of control over the assets (choosing investment options, designating beneficiary, and making withdrawals). |
| **Accelerated Gift Tax Treatment** |
| Individuals making contributions to a 529 Plan can elect to receive accelerated gift tax treatment, enabling them to make the equivalent of 5 years of gift tax-free transfers in one year. In 2016 (as indexed), rather than being limited to $14,000 per beneficiary per year ($28,000 if married and making split gifts) without triggering gift taxes, individuals can make up to 5 years of contributions in a lump sum (up to $70,000 per beneficiary for single contributors and $140,000 for married contributors) without triggering gift taxes.  One caveat to making this election is if total contributions to each beneficiary exceeds five times the annual gift tax exclusion, the excess amount is treated as a taxable gift in the year of contribution. |

## Capitalizing on Opportunities: Selecting the Appropriate Education Savings Vehicle

As you can see, the range of education savings vehicles available to affluent clients is numerous, each with its own merits and weaknesses. The key issue is selecting the right vehicle, given a particular client’s unique circumstances. The importance of helping clients be truly thoughtful in this analysis is captured in this true story.

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| **James Kelly’s Story** James Kelly contacted Frank Johnson, his advisor, 15 years ago and inquired about setting up an account for his son, who had just turned three. Frank spent a few minutes sharing war stories about the joys of raising a young son and then proceeded to talk business.  James said he wanted to start setting aside some money for his son’s education and wanted to know the best way to do it. Frank quickly replied, “Let’s just set up an UGMA, which will put the money in your son’s name but enable you to maintain control over how the money is managed.” And so, it was. The account was set up and James funded the UGMA with 3000 shares in a start-up venture run by two of James’ friends.  Fast forward to a few months ago when James called Frank and was obviously troubled, and rightfully so. The account he had set up years ago for his son had performed quite well. In fact, the account, valued at just over $15,000 at the time it was set up was now worth over $3.2 million, and his son would be turning 18 in just a few weeks, giving him full and unfettered access to this wealth. |

The following are effective questions you can use to engage your clients in a meaningful dialogue designed to identify the most appropriate education savings vehicle for them.

Description: DocumentationIcon_32px**Click the icon to view some effective questions.**

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| **Awareness Questions**   * How has your advisor worked with you to assess pros and cons of the education savings alternatives available to you? * How has your advisor helped you identify the most tax-efficient approach to saving for your child’s education? * How have they worked with you to select the education savings vehicle that affords you the optimal combination of tax-efficiency and control? |

## Common Client Questions About 529 Accounts

At this point, you should have a fairly comprehensive understanding of 529 Plans. However, as with any relatively new planning strategy, there are myriad questions that may arise in the day-to-day conversations with your clients. The following is a Reference Guide of some of the common questions that clients may pose. It is important that you cross-reference this information with any laws specific to your state and the specific guidelines of the Plan(s) you are offering.

**Click the icon next to each question to see the answer.**

|  |  |
| --- | --- |
| Description: DocumentationIcon_32px | **Who Can Establish an Account?** |
| **Answer:**  Any U.S. citizen or legal U.S. resident can set up a 529 Plan account. Minors can establish an account; however, a parent or guardian must sign the account application. | |
| Description: DocumentationIcon_32px | **Are 529 Plans Guaranteed?** |
| **Answer:** Certain Prepaid Plans are guaranteed by the sponsoring state. You must refer to the individual state's plan to make that determination. Savings Plans, on the other hand, are never guaranteed. | |
| **Description: DocumentationIcon_32px** | **What are the Contribution Limits to a 529 Plan?** |
| **Answer:** Although contribution limits vary by Plan and by state, the maximum contribution to any Plan may currently exceed $300,000 per beneficiary, while the median limit is just over $235,000. At such time as the value of the account reaches the plan's maximum limit, either through contributions and/or growth, no more contributions can be made to that account. But again, limits will vary by state, and should always be verified. | |
| Description: DocumentationIcon_32px | **What Constitutes "Qualified Expenses"?** |
| **Answer:** Qualified expenses include tuition, books, fees, room and board, supplies and equipment for enrollment (must be enrolled on at least a half-term basis) and certain special need expenses at an Eligible Educational Institution as defined by Title IV of the Higher Education Act of 1965. Most colleges, universities, community colleges, vocational schools, and even some foreign institutions qualify. | |
| Description: DocumentationIcon_32px | **Can I Use 529 Plan Assets to Pay For Elementary and/or High School Tuition and Fees?** |
| **Answer:** Not without paying Federal income tax and a 10% penalty. | |
| Description: DocumentationIcon_32px | **Who Owns the Account if I Die?** |
| **Answer:** A successor owner is typically selected upon opening of the account. If no succession is defined, in most states the estate of the deceased owner becomes the owner of the account. | |
| Description: DocumentationIcon_32px | **What are the Estate Tax Consequences if the Account Owner Dies?** |
| **Answer:** The account is not included as part of the owner's estate. If, however, the owner dies within five (5) years of taking advantage of the special annual gift tax exclusion made to accelerate gifts to the beneficiary, the portion of the gift(s) allocated to the years after the account owner's death will be included in the account owner's estate. When calculating recapture, keep in mind that the annual gift tax exclusion amount was $11,000 from 2002 - 2005, $12,000 from 2006 - 2008, $13,000 for 2009 – 2012, and $14,000 for 2013 through 2016. | |
| Description: DocumentationIcon_32px | **Can I Roll Over Assets from One 529 Plan to Another?** |
| **Answer:** Yes, rollovers can be made from one 529 Savings Plan to another once every 12 months or whenever a beneficiary change is made. | |

## Common Client Questions About Beneficiaries

Similar to the previous page, the following are some potential questions that clients may have regarding beneficiaries. Again, it is essential to cross-reference this information with any laws specific to your state and the specific guidelines of the Plan(s) you are offering.

**Click the icon next to each question to see the answer.**

|  |  |  |
| --- | --- | --- |
| Description: DocumentationIcon_32px | | **Who Can I Select as a Beneficiary?** |
| **Answer:** The contributor can select any U.S. citizen or legal resident as the beneficiary. The beneficiary does not have to be a family member. You can even select yourself as beneficiary. | | |
| Description: DocumentationIcon_32px | **Can I Change the Beneficiary?** | |
| **Answer:** Generally, you can change the beneficiary. However, to avoid Federal income tax and the 10% penalty, the new beneficiary must be a family member of the original beneficiary. Also, for Prepaid Plans, this may require an adjustment to the premium.  Eligible family members of the original family member include:   * A son or daughter or a descendent of either * A stepson or stepdaughter * A brother, sister, stepbrother or stepsister * A father or mother or an ancestor of either * A stepfather or stepmother * A brother or sister of the father or mother * A son or daughter of a brother or sister * A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law * The spouse of the beneficiary or the spouse of any individual described above * A first cousin of the beneficiary | | |
| Description: DocumentationIcon_32px | **What Happens if the Beneficiary Receives a Scholarship?** | |
| **Answer:** The account owner can withdraw assets commensurate with the value of the scholarship. The withdrawal is subject to Federal income taxes but will not be charged the 10% Federal tax penalty subject to non-qualified withdrawals. | | |
| Description: DocumentationIcon_32px | | **What Happens if the Beneficiary Becomes Disabled or Dies?** |
| **Answer:** The account owner can withdraw the funds. The withdrawal is subject to Federal income tax but will not be charged the 10% Federal tax penalty levied on non-qualified withdrawals. | | |
| Description: DocumentationIcon_32px | **What Happens if My Beneficiary Decides Not to Go to College?** | |
| **Answer:** The account owner can change beneficiaries subject to the rules stated above or simply withdraw the funds and pay the Federal tax and 10% penalty. | | |
| Description: DocumentationIcon_32px | **What Happens with a Prepaid Plan if the Beneficiary goes to a Private or Out-of-State School?** | |
| **Answer:** In that case, the funds can be applied to the private or out-of-state school, but the amount would have nothing to do with the actual costs of the private or out-of-state school. Instead, the funds available would be equal to the average cost of attending an in-state public school. | | |
| Description: DocumentationIcon_32px | **What are the Estate Tax Consequences if the Beneficiary Dies?** | |
| **Answer:** The assets in the account are included in the beneficiary's estate. | | |

## Step #3: Educate Clients on Potential Tax Credits

The final step is to educate clients on potential tax credits that may be available to them. There are two tax credits and three deductions that individuals can potentially use to ease the burden of rising education expenses:

|  |  |
| --- | --- |
| **Overview** | **Click each tax credit on the left for more information.** |
| **The American Opportunity Tax Credit** | This credit is 100% of qualified tuition, fees, and course materials paid by the taxpayer for the taxpayer's or dependent's qualified higher education expenses, up to $2,000 plus 25% of the next $2,000 of expenses. Thus, the maximum AOTC is $2,500. This credit is applied on a per-student basis, enabling families to claim the credit for each family member attending a qualified post-secondary school at least half time in any one year.  **Restrictions**:  This credit is only applicable to the child’s first four years of post-secondary education. Also, it cannot be used for courses that do not result in a degree or certificate. Furthermore, the AOTC, the Lifetime Learning Credit, or Tuition and Fees Deduction cannot be claimed for the same student in the same year; i.e., only one is allowed per student each year.  For the tax year 2016, this credit phases out for single filers with modified AGI of $80,000-$90,000 and joint filers with modified AGI of $160,000-$180,000. Other limitations may apply and the client should consult his or her tax advisor regarding use of this credit. |
| **Lifetime Learning Credit** | Similar in structure to the AOTC, the Lifetime Learning Credit enables families to claim a tax credit for qualifying education expenses or for expenses associated with part-time classes at a qualifying educational institution taken to improve or upgrade job skills. Specifically, families can claim a credit for 20% of the first $10,000 of qualifying tuition and fees. (Note: This credit maximum is $2,000 per family, not per taxpayer/dependent.)  **Restrictions:**  The AOTC, the Lifetime Learning Credit, or Tuition and Fees Deduction cannot be claimed for the same student in the same year; i.e., only one is allowed per student each year. This credit phases out for taxpayers earning beyond certain levels of income (indexed for inflation). For the tax year 2016, the credit phases out for single filers with modified AGI of $55,000-$65,000 and for joint filers with modified AGI of $110,000-$130,000. Other limitations may apply and the client should consult his or her tax advisor regarding use of this credit. |
| **Student Loan Interest Deduction** | Interest paid on private or government-backed loans for qualifying post-secondary education and training expenses (including tuition, fees, books, equipment, room and board) is an “above the line” deduction in calculating adjusted gross income (whether or not the taxpayer itemizes deductions). The maximum allowable deduction in any one year is $2,500.  For the tax year 2016, this deduction phases out for single filers with modified AGI of $65,000-$80,000 and for joint filers with modified AGI of $130,000-$160,000 (phase out limits are indexed for inflation). Other limitations may apply. The client should consult his or her tax advisor. |
| **Tuition and Fees Deduction** | Tuition and certain related expenses for a qualified student paid to an eligible post-secondary educational institution can also be an "above the line" deduction in calculating adjusted gross income. This Tuition and Fees Deduction was extended through 2016 by Congress in December 2015.  The maximum deduction is $4,000 in 2016 if the taxpayer's Modified AGI is less than $65,000 (Single/Head of Household/Qualifying Widow(er)) or $130,000 (Married Filing Jointly).  Between an MAGI of $65,000-$80,000 (S/HOH/QW) or $130,000-$160,000 (MFJ), the maximum deduction is $2,000.  The taxpayer is not eligible for the deduction if MAGI exceeds $80,000 (S/HOH/QW) or $160,000 (MFJ).  **Restrictions**:  If a taxpayer utilizes an educational tax credit, this deduction is not available for the same student in the same tax year or vice versa. The taxpayer must reduce the qualified education expenses by the amount of any tax-free educational assistance and refunds received. Other limitations may apply and the client should consult his or her tax advisor regarding use of this deduction. |
| **Business Deduction for Work-Related Education** | An employee taxpayer may be able to deduct work-related education expenses as a miscellaneous itemized deduction to the extent that certain miscellaneous deductions exceed 2% of the taxpayer's AGI. A self-employed individual would deduct qualifying education expenses from self-employment income. This deduction would not typically prevent the taxpayer from utilizing the above listed credits and deductions.  **Restrictions**:  To deduct the work-related education expenses, two tests must be met:   * The taxpayer's employer must require the education to maintain the taxpayer's salary, position, or job status. The required education must serve a bona fide business purpose for the taxpayer's employer. * The education maintains or improves skills needed in the taxpayer's work.   Note that the education expenses will not be deductible if the education is needed to meet the minimum educational requirements of the taxpayer's trade or business or, if the education qualifies the taxpayer for a new trade or business. Other limitations may apply and the client should consult his or her tax advisor regarding use of this deduction. |

## Review Exercise

**Review the preceding material by answering the following questions.**

1. **Through accelerated gift tax treatment, how much can a married couple contribute in 2016 to a 529 Plan in a lump sum without triggering a gift tax?**

* $28,000

**Incorrect.** Try again.

* $42,000

**Incorrect.** Try again.

* $70,000

**Incorrect.** Try again.

* $84,000

**Incorrect.** Try again.

* **$140,000**

**Correct.** Normally, they can contribute $28,000 per year. But the donor may elect to gift up to 5 times the annual gift tax exclusion in a single year (5 x $28,000).

1. **Oddly enough, while 529 Plans are tax advantaged for Federal income tax purposes, there is no tax-advantage for state income tax purposes.**

* True

**Incorrect.** In some states, contributions may be deductible.

* **False**

**Correct**. In some states, contributions may be deductible.

1. **Every state has a Savings Plan.**

* **True**

**Correct.**

* False

**Incorrect.**

1. **Provided all distributions are qualified, all earnings in a 529 Plan will totally escape Federal income taxation.**

* **True**

**Correct.**

* False

**Incorrect.**

## Conclusion

Given the rising costs of education, now more than ever it is vital that you as an advisor are well equipped with the knowledge and ability to help clients develop sound education planning strategies.

This material has provided you with a comprehensive overview of the key issues you must help clients address to achieve their education savings goals by focusing on the three key questions in the education planning process.

|  |
| --- |
| **Planning Questions and Key Points** |
| **How much should I save?** |
| * Estimated costs * Education Inflation Rate: 6% |
| **What vehicle should I use?** |
| * Traditional Investment Account * UTMA/UGMA * Coverdell ESA * 529 Plans |
| **What education tax credits or deductions are available?** |
| * The American Opportunity Tax Credit * Lifetime Learning Credit * Student Loan Interest Deduction * Tuition and Fees Deduction * Business Deduction for Work-Related Education |

This concludes the material for this subject. At this time you may return to any sections in which you feel the need for further study.