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It's Not Your Father's Tuition Bill!

Escalating college expenses make saving for education a real challenge. Recent legislation on the "kiddie tax" affects the traditional savings approach of transferring income-producing assets to your child. Effective in 2008, unearned income over $1,700 is taxed at the parent's rate if the child is under 19 (under age 18 for 2007), and expanded to age 23 if a dependent is a full-time student.

<u>529 Plans</u>

Although not tax deductible, contributions are eligible for the annual gift tax exclusion ($12,000 in 2007). Earned plan income is tax-free if it is used to pay qualified higher education expenses (QHEE) when withdrawn. QHEE include tuition, fees, books, supplies, required equipment and (if at least a half-time student in a degree program) room and board. Any income not used for QHEE is taxed at the normal rates plus a 10% penalty tax. You can replace a beneficiary with a qualified family member or rollover to another plan. Both higher education institutions and states (Illinois has 3 plans) have created plans which include college savings and prepaid tuition programs. Plans differ, so buyers beware!

<u>Coverdell Education Savings Accounts (ESAs)</u>

Annual contributions are limited to $2,000 and start to phase out once the contributor's modified adjusted gross income exceeds $95,000 ($190,000 for joint returns). A child, however, can contribute to her own account to avoid the phase-out. The ESA must be a trust or custodial account and the trustee or custodian generally must be a bank. Like the 529 Plan, income accumulates tax-free and distributions are tax-free if used for QHEE. An ESA may also be used to pay qualified elementary and secondary education expenses. Rollovers are allowed into another ESA for the same beneficiary or for certain family members. Both a 529 Plan and an ESA may be established for the same beneficiary.

<u>Other Options</u>

Series EE and Series I U.S. savings bond interest may be tax-free if used for tuition and fees at a college or graduate school, but the bonds must be owned by the parents and used for a dependent (or themselves). This exclusion is subject to phase-out rules and unused proceeds are taxed at normal rates. Also consider purchasing municipal bonds which are exempt from federal taxes and, in certain circumstances, may be exempt from state taxes. There are no limits on the amount of annual investment or the use of the proceeds.

Reminder: If you make estimated tax payments, the third estimate for 2007 is due September 17!