HOW TO PAY FOR COLLEGE: TAX SAVVY TIPS FOR PARENTS

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TABLE OF CONTENTS:

How to Pay for College: Tax Savvy Tips for Parents

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I. THE STATE OF EDUCATION IN AMERICA

A. Overview.

1. Higher Education – a.k.a. college – was once the province of the elite. Today, however, "higher education" is for all intents and purposes a necessity in order for young adults to participate and prosper in our ever more complicated, differentiated and technologically sophisticated world.

2. The problem is that the cost of college has risen at a rate dramatically above the inflation rate over the past generation. As recently as the 1970s, college tuition at well respected state universities was often "free" -- meaning the tuition charge for in-state students was actually zero. Even exclusive private schools in those years were priced in the "affordable" range.

3. US government is at the center of the modern educational matrix, and more than a few people suggest that the government is the principal catalyst for this inflationary cost spiral, but that is a loud and contentious political discussion for another day. What this seminar will attempt to address is the various resources available to help parents pay for college in its existing (expensive) configuration, and – most importantly – how to get the maximum benefit at the lowest possible cost from this increasingly extravagant expenditure.

4. There is no Constitutional "right" to a high-quality public education, but most Americans actually tend to believe the opposite. As a practical matter, every state provides a free public education for primary and secondary school, and generally imposes mandatory school attendance (or participation) requirements on minors until a specified statutory age.

5. At the levels above secondary education, US education becomes the financial burden of the individual seeking the education – and, of course, the family of that individual.

6. There are, in turn, a vast array of possible financial resources to assist an individual in pursuing higher education, including:

a. scholarships or grants from the school itself (which can be academic, scholastic and/or athletic);

b. scholarships, grants and awards from various other organizations, including from federal and state government (NOTE: there are a TON of scholarships out there if you know where and how to look for them);

c. various tax incentives and tax benefits provided under federal and state tax law to help defray or “share” the cost of college; and

d. various lending resources to help finance the costs through loans, provided primarily by or through the federal government, but also through some banking or private lending institutions.

7. The purpose of this seminar is to help parents and students put together a practical package that enables a young adult to pursue and obtain a valuable education at an affordable price.

B. The Astounding Escalation in Tuition and Room and Board Costs.

1. Grim statistics show that the cost of a college education has escalated dramatically over a long period of years. In the 1970s and 1980s, the cost of a four-year college education was approximately the price of a good new automobile. Today, the cost of a college degree can be closer to the cost of a new house – especially if the student elects to pursue a graduate-level degree. In turn, the amount of money required to fund a college education has risen from the equivalent of a car loan to the equivalent of a house mortgage.

2. The growth in colleges costs (tuition plus room and board) have risen more slowly in recent years (since 2008), but still increase on an average of 2 to 4% per year, and continue to outpace inflation. As this seemingly endless cost spiral soaks up family wealth, many high school graduates are increasingly forced to choose between a staggering debt load or no college education.

3. According to Time magazine, about one-half of the students who graduated with a bachelor degree in 1994 were burdened with debt for college, and the student debt amount averaged out to be about $10,000 per borrower. Twenty years later, two-thirds of all students that graduate with bachelor degrees are now leaving school with both a diploma and a student debt burden, and the average debt burden is now $35,000.

4. Saving early is the best way to ensure that your child will be able to get a quality college education without taking out big student loans. The good news is that one dollar saved and invested today, including in a 529 Plan, will be worth more than two dollars that would otherwise be needed later in time to repay student loans.

5. In addition to saving and investing for college, other complementary strategies include

a. using greater selectivity in choosing a college (i.e., the decision these days should be based on the value proposition rather than on the prestige of the college);

b. aggressive pursuit of available scholarships, awards and other outright "gifts;" and

c. efficient use of the tax incentives provided by federal and state governments.

C. <u>Tax Incentives Available to Help Pay for College.</u>

1. The first and best way to afford college is to save and put aside money from the beginning and invest it wisely. The eighteen years between birth and freshman orientation week is a LONG TIME and money invested early and astutely can provide a solid start to a financial plan for college.

2. The investment plans established under Internal Revenue Code Section 529 (referred to herein as "529 Plans"), are among the best options for financing a college education because the investment growth in a 529 Plan is not subject to federal income tax (and usually not subject to state tax) so long as the funds are later withdrawn and used to pay for qualifying educational expenses at an accredited college. A 529 Plan, used successfully, is the equivalent of setting up a Roth IRA for a child's college education – after-tax contributions compounding tax-free for a long period of years.

3. Some states enhance the value of a 529 Plan by allowing a state income tax deduction for contributions to a 529 Plan. 529 Plans will be discussed in detail in the materials below, including how to identify the best 529 Plan for a particular person.

4. There are a variety of other federal and state tax incentives available to help finance education, including the following:

a. American Opportunity Tax Credits ("AOTC");

b. Lifetime Learning Credits ("LLCs"); and

c. Tuition and Fees Deduction.

Each of these federal tax incentives is discussed in further detail, below.

D. <u>The Declining Productivity of Education</u>

1. The Brookings Institution, a well-regarded (and conspicuously liberal) think tank, has lamented the "declining productivity" of US education – a euphemism for the poor value proposition that a college education increasingly represents to US student/consumers.

2. Brookings notes that only about half the people born around 1980 earn more today than their parents did at a similar age. That standard, once upon a time, was the proof that the American Dream was forever expanding, because children almost always made more than their parents did at the same age.

3. Brookings identifies the nation's "deteriorating educational sector as one important factor, culpable for both weak economic growth and rising income inequality."

4. The undeniable fact is that personal educational costs have soared. College tuition, net of subsidies, is 11.1 times higher in 2015 than it was in 1980. This compares to an increase by about a 2.5 factor in overall personal consumption. For private education and the K through 12 sector, meanwhile, prices are 8.5 times higher than they were in 1980.

5. For all of this increase in spending on American education, learning has stagnated. Based on testing of 17-year-old American teenagers, there have been literally zero gains in literacy since the National Assessment of Education Progress began in 1971. The performance is slightly better in math, but even in math, there has been no progress since 1990. This stagnation is not attributable to racial or ethnic changes in the US population. The literacy score for white students peaked in 1979, and the math scores peaked in the early 1990s.

6. The failure of American education stands starkly in contrast to the performance in other countries. According to Brookings, in the average OECD country, for people born between 1978-1987, the age group scored significantly better than all previous generations. When comparing older-aged groups (1947-1957) to the younger-aged groups (those born between 1988-1996), the US performance is especially embarrassing. The United States ranked dead last among 26 countries tested on math gains, and scored second-to-last on literary gains, across these two generations. Countries that have made the largest math gains include South Korea, Slovenia, France, Poland, Finland, and the Netherlands. Given that the US far outspends every other country on a per-student basis, the poor performance is especially troubling.

7. Brookings notes that the major factor driving costs has been the growth of "highly-paid non-teaching professionals." In 1988, for every 100 full-time equivalent students, there were an average of 23 college employees. By 2012, the number increased to 31 employees, with a shift toward the highest paying non-teaching occupations. Managers and professionals now outnumber faculty, who comprise just one-third of the higher education workforce. How is this dramatic increase in cost being funded? The rising costs have been absorbed by increased student borrowing, which is subsidized almost entirely these days by the US government and supplemented in some cases through grant aid. The Brookings Institution Report further notes that federal loans have gone increasingly to the worst-performing colleges, as viewed from the perspective of default rates.

8. Magnifying these negative changes is the fact that teaching itself has become an increasingly unattractive profession. Salaries for teachers start low, in comparison to the education required, and never become particularly attractive or competitive. School systems impose a host of bureaucratic constraints that teachers find frustrating. Good teachers are not easily rewarded or promoted, and bad teachers are not easily sanctioned (and almost never fired). The teaching environment itself has become unrewarding and even hostile.

9. The declining productivity of education harms everyone, but this has a disproportionately harmful effect on the poor. The rising costs of education are not and probably can never be fully offset by redistributive mechanisms. The society over the past 40 years has experienced greater inequality, and less economic growth, than almost any other country in the world. It is, to say the least, a high price to pay for the high cost of education.

E. The Prestige (Snobbery) Factor in Choosing College.

1. Schools have been ranked in terms of "quality" -- and in prestige -- since the beginning of time and the origins of higher education. People are inexorably drawn to the prestige of a premier college or university – applicants want to attend it, alumni want to contribute to it, and teachers want to teach at what is perceived as a world-class institution.

2. One of the interesting measures of college prestige is the ranking of schools by endowment. According to Money Magazine, January 25, 2018, the following is the list of the 25 largest college endowments at the end of 2017:

College	2017 Endowment Value	% Change in Market Value	Value per Student
Harvard University	$36.022B	4.3	$1,522,104
Yale University	$27.176B	7	$2,191,268
The University of Texas System	$26.535B	9.60	$147,675
Stanford University	$24.785B	10.70	$1,541,160
Princeton University	$23.812B	7.5	$2,951,077
Massachusetts Institute of Technology	$14.968B	11.4	$1,315,751
University of Pennsylvania	$12.213B	14	$541,389
The Texas A&M University System	$11.556B	9.60	$97,189
University of Michigan	$10.936B	12.20	$197,056
Northwestern University	$10.437B	8.20	$568,540
Columbia University	$9.997B	10.60	$389,018
The University of California	$9.788B	17.3	$36,235
University of Notre Dame	$9.352B	11.70	$762,463

Duke University	$7.911B	15.70	$509,248
Washington University in St. Louis	$7.861B	11.4	$562,770
The University of Chicago	$7.524B	7.5	$487,698
Emory University	$6.905B	7.9	$493,635
Cornell University	$6.758B	13.20	$288,941
University of Virginia	$6.394B	9.20	$277,836
Rice University	$5.814B	9.20	$872,778
University of Southern California	$5.128B	11.3	$127,612
Dartmouth College	$4.956B	10.8	$782,398
The Ohio State University	$4.253B	18.90	$70,612
Vanderbilt University	$4.136B	9	$342,139
New York University	$3.992B	14.5	$89,774

3. Interestingly, the 2017 Tax Act now imposes, as of 2018, a 1.4% tax on the growth of endowments where the size of the endowment exceeds certain thresholds based on the ratio of the endowment to the number of students attending the institution in question. Do not be surprised if this tax on endowments continues to escalate in coming years.

4. This is quote from a article in Mother Jones magazine from 2015:

> A New York Times op-ed published Wednesday by Victor Fleischer, a law professor at the University of San Diego, lays out this disparity. Fleischer cited Yale University, which paid its fund managers nearly $743 million in 2014 but gave out just $170 million in scholarships. He also noted that many universities, large and small, public and private, show the same imbalance in spending. "We've lost sight of the idea that students, not fund managers, should be the primary beneficiaries of a university's endowment," he writes. "The private-equity folks get cash; students take out loans."

5. The cruel-but-accurate joke is that "Harvard University is a large tax-exempt hedge fund that also owns and operates a small liberal arts college."

F. How the *US News and World Reports* Rankings Affect Colleges

1. The magazine US News and World Reports -- sometimes referred to mischievously as "US Noise and World Reports" -- has for many years been the quasi-official "ranking" organization of colleges and universities. These rankings have a huge impact on the $680 Billion industry that one might call Big Education: rankings affect the number of applications, the quality of applicants, the amount of contributions by alumni, and the sense of satisfaction (prestige) among faculty and administrators.

2. The following is an excerpt from Wikipedia about these rankings:

> "U.S. News & World Report is an American media company that publishes news, opinion, consumer advice, rankings, and analysis. Founded as a newsweekly magazine in 1933, U.S. News transitioned to primarily web-based publishing in 2010. U.S. News is best known today for its influential Best Colleges and Best Hospitals rankings, but it has expanded its content and product offerings in education, health, money, careers, travel, and cars. The rankings are popular in North America but have drawn widespread criticism from colleges, administrations, and students for their dubious, disparate, and arbitrary nature. The ranking system by U.S. News is usually contrasted with the Washington Monthly and Forbes rankings."

3. Among the factors taken into account in the U.S. News ranking formula, according to Politico.com, are:

a. *Student performance* on standardized admissions tests, which correlate strongly with family income, more than high school grades, which have less of a correlation.

b. *Having a lower acceptance rate***,** which many colleges have sought to achieve by leaning more on early decision admissions; this hurts lower-income students who apply to more schools in order to compare financial aid packages.

c. *Performing well on surveys* of high school guidance counselors from highly ranked high schools, while many high schools in less affluent areas have few or no counselors.

d. *Alumni giving***,** which creates incentives to appease alumni by accepting their kids.

4. Colleges, not surprisingly, have a strong desire to boost their rankings, and often try to enhance their ranking through various initiatives and administrative practices.

5. The following is a quote from Politico.com:

> Southern Methodist University in Dallas conducted a billion-dollar fundraising drive devoted to many of the areas ranked by U.S. News, including spending more on faculty and recruiting students with higher SAT scores — and jumped in the rankings.

Meanwhile, Georgia State University, which has become a national model for graduating more low- and moderate-income students, dropped 30 spots.

6. Known strategies that have been used to help achieve a higher ranking in US News and World Reports include the following:

a. Manipulating the Number of Applicants -- Schools market to students who have little chance of earning admission, such as students with test scores well below the school average. The more students who apply — even if they are not qualified — the lower the school's admission rate. The Washington Post noted, "First, colleges have boosted the denominator in that calculation by purchasing names of test takers and employing business-like marketing techniques to encourage applications from students they have no intention of ever accepting."

b. Manipulating the Admissions Process -- Gary Saul Morson points out, "Some selective schools go to supposed 'wait lists' long before the national response date of May 1. If a student is unlikely to come — say, because her scores are way above your school's average — put her on the wait list, then call the next day and tell her that if she decides right then to accept an offer of admission, she is in. If she asks to think about it, go on to the next applicant. No wonder the yield off the wait list is so high. Unless a student agrees to come, she was never admitted!"

c. Manipulating Test Results -- Some colleges no longer require applicants to report SAT or ACT scores. This is actually a device that allows colleges to exaggerate the "reported" SAT and ACT scores. To absolutely no one's surprise, applicants with high scores report their scores, and applicants with low scores do not. However, when colleges report their "average" applicant scores, they then take only the scores voluntarily reported, which skews the information considerably.

d. Manipulating Delayed Admissions -- Some colleges do not offer admission to students for the fall. Instead, they offer them a chance to matriculate in the spring or even in the subsequent year — through a guaranteed transfer offer. These admitted students so often do not count as admits for college rankings. Rather, they count as students who were denied admission, further lowering that admission rate.

e. Manipulating Early Admissions – The Washington Post noted, "Northwestern University, for instance, in a recent year announced it had reached a record-low acceptance rate. What it didn't make clear is that its early decision acceptance rate was 35 percent and it filled 55 percent of its class that way."

7. Some law schools have boosted their "success" rate for graduates by offering a one-year paid position at the law school following graduation. This is then counted as a graduate who is employed following graduation.

II. PAYING FOR COLLEGE – SAVING FOR COLLEGE THROUGH A 529 PLAN

A. Quick Observations and Comments on the Use of a 529 Plan.

1. The 529 Plan is arguably the best way for parents and grandparents of a young child to put aside money for college. 529 Plans permit heavy "front loading" of contributions and allow investment income to be withdrawn tax-free if spent on qualified educational expenses." If the money is well invested, the tax savings is considerable.

2. A detailed memorandum, addressing the many complicated and nuanced aspects of a 529 Plan, is attached to this Outline as Exhibit A.

3. The 529 Plan was originally tailored to paying for college "qualified educational expenses" – and now, thanks to the 2017 Tax Act, can also be used to pay for K-12 private school (only for tuition and maximum of $10,000 of tuition expenses)

4. A contributor can "supercharge" a 529 Plan by making a contribution equal to five years of the annual exclusion amount under Code Section 2503(b), or $75,000 in 2018, and the money can stay invested tax-free until college, which can be 20 years or more in the future.

5. Market timing on withdrawals is very complicated because withdrawals must be spent within a relatively short period of time on qualified educational expenses.

6. An interesting issue is how best to withdraw $100,000 from the account if it will only cover a year or two of school. Should you take more out earlier if market is high? If market drops you don't have a time horizon to make it up. Will it help to deplete assets and then apply for aid or scholarships in the third and fourth year?

7. The investment choices in a 529 Plan are generally circumscribed, although they have gotten better over the years. A logical strategy is to invest relatively aggressively in earlier years, but then consider a reallocation to more conservative investments as college approaches. Going to college is the "retirement event" for a 529 Plan.

8. A 529 Plan has the flexibility to pay a broader range of education-related expenses than direct payments to a University under 2503(e).

9. If someone names themselves the owner and the beneficiary, and you can later change to a child, and this may be a sensible structuring strategy. You can even give the money to yourself for education should the urge for self-improvement move you.

10. 529 Plan if it is not used for the intended beneficiaries becomes a defacto IRA. A withdrawal by the owner is subject to a 10% penalty on the gain, plus state and federal income tax on the gain portion of each distribution. There is also state recapture income if there was a state deduction going into the 529 Plan.

11. Taxpayer is issued a Form 1099-Q, and if you cannot prove the withdrawal was spent on qualified expenses it is a taxable distribution.

12. You can have multiple 529 Plans – Mom, Dad, Grandparents, Uncles and Aunts. Almost all 529 Plans have a limit on contributions if the account exceeds a maximum level. There is a link that shows each state maximum. See the website

Www.savingforcollege.com for full details. State limits are increasing relatively rapidly in recent years. CT still at $300,000, MA is at $400,000, NY is at $500,000, MI is at $500,000.

13. A 529 Plan can have a generation-skipping advantage. Assume you create a 529 Plan for five children, and still have $250,000 left over after they graduate. It is possible to create five new accounts, one for each child, make the child the owner/beneficiary, and the children can use it for their children (the grandchildren). Some states allow unborn beneficiaries, so you can name all your heirs.

14. You can also name a trust as the "owner" of a 529 Plan. One problem is that the Trust may have required language on distributions, and this can create potential problems if a 529 Plan has surplus funds after the named beneficiaries of the Trust have graduated from school. But trust language can be drafted so that the money is held in the 529 Plan for future generations.

15. Picking the appropriate state plan is always a challenge. The plans have gotten much better – they were initially characterized by very limited investment options but most are now much better. Some are advisor assisted plans and you pay for that advice, but the fees charged on direct investment are usually very low. .

B. Standard (Taxable) Investment Accounts.

1. Tapping into a regular taxable investment account is generally better than tapping into your Roth IRA.

2. For wealthy clients this is often a better alternative than a 529 Plan. It avoids the restricted use issues that apply under a 529 Plan.

C. Regular IRA and 401(k) Plans.

1. Early withdrawal is now permitted without penalty if the money is used for educational purposes.

2. A withdrawal triggers taxable income to withdrawing beneficiary, but the transfer for education can generally be structured to be a non-taxable gift transfer gift under Code Section 2503(e).

D. ROTH IRAs.

1. Roth IRAs are a fabulous investment vehicle for individuals, and for that reason this is probably the LAST place from which to withdraw money for college expenses.

2. Set up a ROTH for you child early in life, but NOT to fund college expenses.

E. Wealth Management and the Use of Trusts in a World of Expensive College Educations.

1. Money left to children or grandchildren in trust can provide various incentives – pay more money out if they get certain GPA, graduate by a certain date, and so forth.

2. Under a 529 Plan the only real "stick" is that the owner can change the beneficiary to a blood relative of the original beneficiary. If an owner gets really unhappy with the conduct of the original beneficiary you need to find a successor beneficiary who is connected by blood. A trust provides much greater flexibility. A really interesting idea is to set up a trust that in turn sets up a 529 Plan.

3. Julie Barron and Jerry Inglet to provide further planning ideas and comments.

III. PAYING FOR COLLEGE – LOANS AND THE ROLE OF THE US GOVERNMENT IN LENDING

A. Student Loans Now Come Almost Exclusively (over 90%) from Government

1. Current outstanding Student Debt is over $1.5 TRILLION dollars, and has grown from $600 Billion in 2005. Just to put it into perspective, this amount is greater than ALL credit card debt, and greater than ALL automobile loans, in the United States today.

2. Following the banking crisis in 2008, the US government became the lender of last resort – and essentially the only lender – on student loans. Before, the banks facilitated the loans, and the government guaranteed the debt. It created a banking relationship with an 18 year old going to college, and that seemed like a good model at the time, especially since the government was guaranteeing the loan. But during the crisis, banks became concerned about liquidity, and made the decision that this was not a profitable business. US government took it over almost out of necessary, so government went from backing to originating the loans. Sallie Mae was a quasi-governmental agency that handled student loans, but Sallie Mae is now a private organization and not even "quasi" governmental.

3. In the old days the lending banks provided hand holding, counselling. Now you just apply to the government. The website at the US Department of Education is as follows: https://studentaid.ed.gov/sa/

4. You apply for government loans by filling out the so-called " Free Application for Federal Student Aid" (FAFSA), by providing information about your income, assets and other financial details. The school provides you with an award letter. You can take out $5500 (referred to as a "Stafford Loan") no matter what. This can be a "subsidized" or an "unsubsidized loan." Subsidized means the loan is not accumulating interest while the student is in school. You are guaranteed to receive additional loan amounts of $6500 as sophomore, and $7500 as junior and senior.

5. Your right to receive these basic loans is pretty much automatic – you just can't have drug conviction. As Jerry Inglet points out, "You can rob a bank, but not a marijuana best." Jerry in fact worked with a student applying for a FAFSA loan who once held up an M&T bank – no problem!

6. There is always a gap between the loan amount and the cost of attending a college, and the onus is on the parents of an undergraduate to fund the difference. A graduate student can always get as much in loaned funds as the graduate student needs. That is typically where people start to rack up major debt. The program is also rife with abuse – graduate students have been known to borrow funds in order to travel to Europe or to invest in Bitcoin.

7. There is a "Parent Plus" loan where the federal government will provide the gap between the FAFSA award and the cost of attendance. It does require good credit standing. There is no debt ratio or requirement of personal assets to secure the loan – this is a classic NINJA[1] loan -- but it does require a good credit rating.

8. Julie Barron notes: If you have a bad credit rating it can strangulate your ability to finance anything.

9. Higher income earning families that have not really saved are pretty badly screwed by the configuration of loans and incentives.

10. Parent Plus loans are only for parents and guardians of the children. If Parent Plus loans are declined, the schools have a slight override to increase the student loan of $5500 by a little, but not much. If you cannot get a Parent Plus loan, you will need a private lender who will accept a co-signer. Co-signed loans appear on both credit reports of the nominal borrower (i.e., the student) and the co-signor. These all factor into debt ratio.

11. That said, if you can secure loans from the federal government, there is a potential to take advantage of "forgiveness" provisions. For example, Public Service Loan Forgiveness is available for federal loans. Whereas private loans are rarely forgiven, federal loans are eligible for forgiveness if you work for ten years in the public or charitable sectors and you pay approximately 10% of your income on payments that are eligible under the PSLF program.[2] You must pay 10% of your income each year for ten years, and you must have concurrent services (30 hours or more) in the public or non-profit sector. At the end of ten years your debt is forgiven AND the debt forgiveness is not income (i.e., is not cancellation of debt income).

12. Government lending is creating a huge hole in the federal budget, and it is unlikely to continue in its current format without some kind of drastic change. Delinquency rates of federal student loans (defined as more than 90 days behind payment) are 11%, whereas most areas of private commercial lending would define "delinquency" as 30 days behind payment and the delinquency rate would normally be in the range of 2-3%.

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[1] "NINJA" loans was a term coined to describe the loans made by banks during the early and mid-2000s, under pressures from the Federal Reserve to make loans that were non-discriminatory by relaxing credit standards. The acronym NINJA stood for "No Income, No Job or Assets". This lax lending policy, coupled with very low interest rates set by the Federal Reserve, helped crash the stock market and almost lead to a complete collapse of the US financial and banking system. See the extremely interesting and accurate book by Gretchen Morgenson and Joshua Rosner, entitled Reckless Endangerment, for a detailed description of this grotesquely irresponsible episode in US political history.

[2] These rules are surprisingly complicated and are not summarized here in full. Look at www.studentaid.gov for a more detailed discussion of the Public Service Loan Forgiveness Program.

13. The total amount of federal debt that has been declared in default (270 days or more behind payment) is presently $74.9 billion, and is owed by 4.3 million borrowers, who owe an average of $17,418.

14. The highest default rates are people who start college and drop out, carrying a resulting debt burden while enjoying no benefit whatsoever from the erstwhile "educational" experience.

15. The worst aspect of all is that federal student loan debt is non-dischargeable, other than by death or disability. Pushing these loans onto students with disadvantaged backgrounds, low family resources, and poor prospects of graduation, is essentially indefensible. It amounts to Reckless Endangerment all over again.

16. The rule of thumb is that the lower on the "feeding chain" the educational institution, the worse the loan default rate. Community Colleges, for example, aspire to bridge the gap between high school and four-year universities, but in fact many have very poor track records. Community Colleges have a 33% graduation rate. The reality is that Community Colleges do, in fact, provide that critical bridge for many students – but too many fall off the bridge, and falling off the bridge saddles them with exorbitant and indefensible amounts of non-dischargeable federal debt.

17. In an article published in 2016 on the website The Hill, entitled "Democrats MIA on student loans,"[3] the author, Alan Collinge, an activist and founder of StudentLoanJustice.org, made the following devastating statement:

> "Anyone who knows anything about this issue knows that student loans have been uniquely stripped of nearly every standard consumer protection there is. Bankruptcy rights, to statutes of limitations, and other core protections that exist for every other type of loan no longer exist for student loans. This has created a hyper-inflationary higher education market, and a predatory lending system the likes of which has never before been seen in this country….the government has no business making the obscene profits that it does off of this program."

B. Student Loans from Other Lending Sources

1. Anyone could theoretically be a lender, but in fact there are specific bank lenders who actively service this market. These include Citizensbank, SunTrust, Wells Fargo, Sallie Mae, Common Bond, PNC, there are a series of them, some are state specific. Go to www.privatestudentloans.guru/ for an extensive list of potential private lenders.

2. There are actually two sectors within this private market for student loans. The first market segment is for what are called "first time origination" loans, and the second market segment is in the refinancing of such loans, typically after a student graduates.

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[3] See the full article at http://thehill.com/blogs/congress-blog/education/285097-democrats-mia-on-student-loans

3. The refinancing market offers a very different risk profile – the student has graduated, may well have started a career and may already hold a good paying job, and these are obviously great people with whom a bank would like to start a lifelong financial relationship. [Contrast this to a freshman asking to borrow $57,000 in order to go to college and major in Underwater Basket weaving.]

4. A major player in the refinancing market is Social Finance, which is based in San Francisco but is a national lender in every state except for Nevada. Other prominent local players in the refinancing market include Citizensbank, First Republic, and CommonBond. See the website at https://www.studentloansguy.com/refinance-market-size/ for an extensive list of potential lenders for student loan refinancing.

C. Home Equity Loans and Parent Borrowing From Private Sources.

1. Parents often borrow money to finance the costs of college. Note that interest on a home equity loan is no longer deductible under 2017 Tax Act.

2. Many private parent loans, including a Home Equity Line of Credit, require interest payments immediately.

3. By contrast, subsidized student loans under the federal Parent Plus program and school loans under some private lending programs, defer accrual of interest until after graduation.

4. In some cases it may be better to let the student borrow the money, defer the initial accrual of interest to graduation, and then develop a strategy to address repayment. Note that student loan interest is deductible up to $2500 as an above-the-line deduction, while parent interest generally will not be deductible.

5. Note that a loan from a private source (e.g., a bank) that is designated as an educational loan is generally non-dischargeable in bankruptcy, and so some banks will accrue and defer payment of interest for a period of time knowing that it is a non-secured loan to the parent but cannot be defaulted and later discharged in bankruptcy.

D. Borrow against the 401(k).

1. Under a 401(k) loan, unlike other types of borrowing, the employee literally borrows the money out of the account and the interest and principal are paid back into the 401(k) account. Thus, if the 401(k) Plan sets the interest rate at 5%, the employee pays the 5% to himself. Some people see this as a form of "interest-free" loan.

2. Some employees have even considered taking out a 401(k) loan as a way to increase the investment returns, by paying 401(k) loan interest at a high rate of return, e.g. 10%.

3. However, paying yourself 10% loan interest doesn't actually generate a 10% return, because the employee who account receives the interest is also paying the interest. It is like transferring money from one pocket to the other – except worse. Unlike a traditional

401(k) contribution, its interest payments to the 401(k) account are not tax deductible. The loan means that there is no net increase in wealth, plus the interest payment becomes taxable when distributed later in time.

4. The effective borrowing cost of a loan from a 401(k) loan is essentially the "opportunity cost" of growing the assets inside the account. Instead, a better strategy for a 401(k) Plan is to contribute the extra money to the 401(k) plan, where it can enjoy the 401(k) tax deduction, earn tax-deferred investment interest (and potential employer matching) on the contribution itself.

IV. VARIOUS OTHER TAX INCENTIVES TO HELP FINANCE COLLEGE.

A. American Opportunity Tax Credit.

1. The American Opportunity Tax Credit (AOTC)[4] provides a credit of up to $2500 per student for the first four years of post-secondary education. The student receives a credit of 100% for the first $2,000 of tuition, fees and course materials, and then a 25% credit against the next $2,000 of such expenses. This comes to the total credit of $2500 with respect to the first 4000 of qualified tuition and related expenses.

2. Up to $1,000 of the AOTC is refundable, meaning it creates a material benefit even if the student has no taxable income during the year.

3. In order to qualify for the credit, a student must be enrolled at least half-time for one or more academic periods during the year. The AOTC credits, it should be noted, do not index for inflation.

4. The AOTC was enacted as part of the stimulus package in 2009, and was made permanent in 2015 under the PATH Act. The AOTC replaced the Hope Credit and is available for more years of schooling (4 years under the AOTC v. 2 years under the Hope Credit), covers a broader range of expenses, and is partially refundable.

5. For 2017 returns, the maximum benefit of the AOTC is subject to a phase-out for single taxpayers when the modified adjusted gross income ("MAGI) reaches $80,000 and is completely phased out for MAGI of $90,000. For married couples, the phase-out range begins at MAGI of $160,000, is completely phased out at MAGI of $180,000. These phase-out thresholds are not indexed for inflation.

B. Lifetime Learning Credit.

1. The Lifetime Learning Credit ("LLC")[5] is an amount of tax credit equal to 20% of the qualified tuition and related expenses paid by the taxpayer during the taxable year for any post secondary education expense, up to a maximum annual credit of $2,000 per taxpayer.

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[4] Code Section 25A(i).

[5] Code Section 25A(c).

2. The credit applies to the combined expenses of all students in the household claiming the credits, a reaches the full $2000 cap when the sum total of all qualifying expenses equals $10,000.

3. The maximum benefit for the LLC phases out for MAGI between $57,000 and $67,000 in 2018 (and between $114,000 and $134,000 for married couples). The phase-out thresholds for the LLC are inflation adjusted annually.

4. The LLC is not a refundable credit, so only taxpayers who have actual tax liabilities for the given tax year can benefit.

5. The LLC does not apply to qualified tuition and related expenses if a student already receives a benefit for those expenses under the AOTC.

C. <u>Tuition And Fees Deduction.</u>

1. The Tuition and Fees Deduction[6] is a deduction of up to $4000 per tax year, with the amount depending on the taxpayer's AGI. This deduction is calculated on Form 8917, Tuition and Fees Deduction, is then carried over and reported as an adjustment to income (an above-the-line deduction) on line 34 of the 2017 Form 1040.

2. The deduction for tuition and fees is allowed to the persons who are actually pays the tuition (including parents, grandparents, students, or spouses) to reduce the taxable income by up to $4000, so long as the taxpayer paid the expenses and claimed the student as a dependent on the applicable federal tax return. You cannot claim the deduction if your filing status is married filing separately, or if another person can claim you as a dependent.

3. The deduction is subject to a "cliff" calculation, such that the $4000 deduction is reduced to $2,000 if the taxpayer's modified adjusted gross income is above $65,000 for a single head of household or qualifying widower, or in the case of married filers above $130,000. There is a second "cliff" such that the deduction a single filers the deduction phases out and is entirely eliminated at $80,000 of MAGI, and for joint filers is eliminated at $160,000 of MAGI.

4. You cannot claim the Tuition And Fees Deduction for any student in the same taxable year that you or anyone else claims the American Opportunity Tax Credit or the Lifetime Learning Credit. However, a state tax credit will not disqualify you from claiming the deduction.

5. NOTE: Taxpayers often have to calculate which alternative federal tax incentive provides the best tax benefit.

D. <u>Student Loan Interest Deduction.</u>

1. The student loan interest deduction allows a student to claim a deduction of up to $2,500 for the interest paid on student loans each year.

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[6] Code Section 222.

2. The maximum deduction of $2,500 is *per return*, and is *not* per taxpayer. Thus, even if both spouses on a joint return qualify for the deduction, the ceiling is $2500.

3. The deduction is subject to a phase out, that begins if modified adjusted gross income is between $65,000 and $80,000 per year for a single filer, or between $135,000 and $165,000 for a joint filer.

4. The student loan interest deduction is an "above the line" deduction in calculating gross income. For tax year 2017, it appears on line 33 on the front of Form 1040. As such, the deduction is not affected by whether or not a taxpayer itemizes deductions (including whether the taxpayer can claim or benefit from deductible mortgage interest). "Student loan interest" is interest you paid during the year on a qualified student loan.

E. <u>Pell Grants.</u>

1. Pell Grants are need-based federal grants that do not require repayment.

2. You file a FAFSA form to apply simultaneously both for a Pell Grant and for a student loan from the federal government. Pell Grants are entirely formulaic, with a maximum award of $6,095 for academic year 2018-19.

3. Pell Grants are based entirely on economic need, and are separate and apart from any federal loans that may be awarded in connection with the same FAFSA filing.

V. THE BEST KEPT SECRET: HUNTING FOR SCHOLARSHIPS

A. Looking for Scholarships in the Right Places

1. Some secondary schools – by no all – have guidance offices and guidance counsellors who do a good job of tracking available grants scholarships

2. For the rest of us, it is a very challenging – but potentially rewarding – exercise to look carefully at grant and scholarship opportunities.

B. <u>Local Scholarships.</u>

1. Look at the graduation programs for the senior year class from the prior year and see what local scholarships were given out. These are very frequently announced and highlighted at the graduation.

2. Look in the local newspapers for announcements.

3. If you have a community service component to high school, see if the organization has a scholarship program associated.

C. <u>Institutional Scholarships.</u>

1. There is a website call <u>www.cappex.com</u> that lists scholarships available at a particular college.

2. Look on the college website to see what scholarships and grants are listed for the specific college. Do a broad internet search related to the college to see if you can pick up scholarships related to the school that the school itself may not capture on the website.

3. National scholarships, the best site www.fastweb.com lists national scholarships. You are competing among thousands of students, but these scholarships tend to be national rather than school specific. These are foundations and national companies that provide scholarships to a broad geographic range of students.

D. Talk to the College – and Do Well in Something.

1. Some colleges are popular and have strong applications, but other schools are competing in a shrinking applicant pool and may be surprisingly willing to make accommodations.

2. Try to find a strength – GPA is one strength, but so are test scores, and sometimes extra curricular activities, such as sports.

3. Standardized test scores almost always improve if you take a test preparation course. The SAT score can be improved by 100 to 150 points. Students who have preparation clearly benefit. There is an associated 115 SAT score increase associated with 20 hours of preparation. This statistic is from Kahn Academy, one of the three major preparation organizations. Kahn Academy is national and free. It can be found on the web at https://www.khanacademy.org/ and offers free sources as well as free preparatory materials.

4. Princeton Review and Kaplan are both national organizations, both charge for services and both are relatively pricey (certainly compared to free). ETREP is a less expensive but more self-driving preparatory service.

5. Be aware that SAT is 50% math while ACT is about 25% math, so if your student is weak at math the ACT is likely to be the better. ACT is more oriented to critical thinking.

6. ACT is rapid fire, question on top of question. SAT is likely to be reading a couple of paragraphs followed by a series of questions.

7. General strategy is to take both SAT and ACT tests and DO NOT REPORT THEM AUTOMATICALLY TO COLLEGE. Only report the score that reflects the best result. Some schools require every test, some allow you to report only the best score, and some allow you to "Super Score" by reporting the best score in each category. 99

VI. SELECTING THE RIGHT COLLEGE

A. Cost v. Quality Issue

1. All economics – and life itself – is about making tradeoffs of cost versus quality. Everyone abstractly wants the "best" education, but that statement comes with highly subjective qualifications and caveats. As I told my daughters when they were applying to

college, Harvard does not have better math than other schools – you learn the same things, just in a different place and possibly in a different way.

2. Data reveals that the majority of students no longer choose their first choice college, and this is based predominantly on cost factors. Cost has become a major factor in the decision.

3. There are three factors: academic, social and financial fit are three factors being weighed by most students and their parents.

4. Depends a lot of learning style. If a student needs support there are schools that will work and schools that definitely will not work. A more independent learning style may do well in a larger, more anonymous university.

5. The best "bang for the buck" in education is probably to start at a Community College and transfer into a four-year college. Too many families are buried in debt these days. They are delaying marriages, delaying buying a home, delaying having children. The number of children living at home is higher than it has ever been. Weight that against the monetary value of living on campus and the incremental value of a four year college versus a two-year college.

6. Get out of school and find an employer to help pay for graduate school.

7. Make a practical decision. People struggling to pay for school is a huge burden and too much of it is going on right now.

8. Within a Community College there are tracks that are successful. A quality student may not feel like it is a competitive group. But there may be an honors college within the Community College, be around others students.

9. Off campus housing in safe surrounding neighborhoods. Cut the cost of room and board in half. If you live away from home, pack you friends into one house. Cut the costs. In NY the SUNY cost is $6500, but dorm is $14,000. Costs more to live there than attend school there. They have high margins on the housing and other amenities.

B. <u>Getting into the College You Want.</u>

1. See slide deck provided by Jerry Inglet.

2. Decide early. Colleges have gone to three step process. Early admissions, early decision, and regular process.

3. Early decision is binding and gives you the best opportunity to get in. January 1 deadline is typical. One institution one time. It gives you no negotiation leverage between two or more schools. It works best if students and parents want one school and are willing to pay the full freight.

4. Early action provides a fast answer but not binding like early decision. Can apply to multiple schools. Not every school offers early action or early decision, but this is

the way to go unless the student needs the fall semester to boost GPA or retake a standardized test. Or if you are being recruited for sports. Otherwise early action is the way to go compared to general admissions.

5. Regular process suffers from the fact that so many students now apply under early action and early decision. The funnel gets tighter at this point so less likely to get into any particular school of your choosing. The funnel gets particularly tight for elite schools, who often recruit more than half the students though early decision and early action,

6. Use the software provided by Naviance, a private software company, to examine detailed information about the high school you are applying from and the college you are applying to. For example, it will tell you how many students from you high school have been admitted at that college, their average SAT, ACT and GPA scores, and related information, so that you can see how you stack up and you potential changes for admission.

C. Heretical Thoughts: Do You Even Need A College Degree?

1. Colleges show graph of college graduates and comparable earnings. But as Jerry points out, correlation is not causation.

2. Bachelor’s degree is often a threshold requirement of many good jobs.

D. Is Free Better than Harvard?

1. The Author recounts a discussion advising a college graduate going to law school about whether to take a full scholarship to a less prestigious school rather than accept an offer to attend more prestigious schools.

2. Julie to discuss books and authorities suggesting strongly that academic success is not really closely correlated to business or life success.

VII. THE RISE OF ON-LINE EDUCATION AS A POSSIBLE SAVIOR FOR US EDUCATION

A. The Small but Growing Trend of Free Tuition.

1. https://www.usnews.com/education/best-colleges/paying-for-college/articles/2018-02-01/these-states-offer-tuition-free-college-programs

2. https://www.nerdwallet.com/blog/loans/student-loans/tuition-free-college/

The following website lists free online courses – often referred to as MOOCs. Some colleges are not accepting transfer credits for some MOOCs. The website is as follows: https://www.mooc-list.com/

<u>EXHIBIT A</u>

To: S&W Tax Briefings File

From: Joseph B. Darby III

Date: May 30, 2018

RE: Basic Description of 529 Plans

A. <u>Summary of 529 Plans</u>

1. A 529 Plan is a tax-advantaged savings and investment program somewhat similar to a 401(k) Plan that is offered and operated by a state or by an educational institution and is designed to help families set aside funds for future college costs – and, as a result of the 2017 Tax Act, it can also be used (subject to limitations) for K-12 private tuition.

2. A so-called "529 Plan" is named after Section 529 of the Internal Revenue Code of 1986, as amended (the "Code"). Code section 529 authorizes the creation of these plans and provides for the specific federal tax benefits described below.

B. <u>Two Types of Section 529 Savings Plans.</u>

Under Section 529 there are two distinct types of plans, which are collectively referred to as a Qualified Tuition Program ("QTP"). The two types of QTPs are as follows:

1. An ***Educational Savings Plan,*** also sometimes described as an investment account, allows a person (such as a parent or grandparent) to contribute money to an account established to meet the qualified higher education expenses of a designated beneficiary or beneficiaries. § 529(b)(1)(A)(ii). The account has the following characteristics:

a. The contributions are treated as completed gifts for gift tax purposes, and the contributions thereafter can grow inside the 529 Plan on a tax-deferred basis for federal income tax purposes. Likewise, most states follow suit and do not tax either the internal investment building up of investments. Many states (over 30) even allow full or partial state income tax deductions for contributions to a 529 Plan.

b. If money is later distributed from the 529 Plan to pay "qualified educational expenses" for a designated beneficiary, the distributions are tax free (i.e., the internal tax-free build up in the plan is never subject to tax) under federal income tax rules and most state rules.

c. The 529 Plan is technically “owned” by the contributor who sets up the account, and the contributor has control over the distributions and investments, and can even alter or change the beneficiaries without penalty provided any new beneficiary is related to the prior beneficiary.

d. There is no income limitation or phase-out imposed on contributors to a 529 Plan, but the plan is subject to a maximum that varies depending on the plan.

2. An ***Educational Savings Plan*** has the following additional technical characteristics:

a. Educational Savings Plans are designed to invest contributed amounts (after-tax non-deductible contributions) in the permitted investments, which typically consist of mutual funds. The balance in the plan grows in accordance with the investment return on the plan investments.

b. Most Educational Savings Plans offer a variety of age-based asset allocation options where the underlying investments become more conservative as the beneficiary gets closer to college age.

c. Educational Savings Plans can only be established and maintained by a state or agency or instrumentality thereof. Code § 529(b)(1)(A)(ii).

d. Although states administer these Educational Savings Plans, the record-keeping and administrative services for these plans are usually delegated to a mutual fund company or other financial services company.

e. Almost every state currently offers an Educational Savings Plan. Virginia’s 529 College Savings Plan is currently by far the largest of the 529 plans. As of October 2013, Virginia 529 was actively managing over $43 billion in total assets and had over 2.2 million active accounts. An article in Money Magazine, dated October 25, 2016 [http://time.com/money/4544294/best-worst-529-college-savings-plans/] rated the available 529 plans and identified Nevada, Utah and Virginia as the top three “Gold Rated” plans.

f. If you're planning to open a 529 plan account, bear in mind that you don't have to invest in the one offered by your own state, although doing so may entitle you to a tax break or other benefits from that state.

3. A ***Pre-Paid Tuition Plan*** allows a person to purchase tuition credits or certificates on behalf of a qualified beneficiary. § 529(b)(1)(A)(i). A Pre-Paid Tuition Plan has the following characteristics:

a. Prepaid Tuition Plans allow a person to purchase tuition credits at today's rates to be used in the future. Therefore, the economic performance of the “investment” is basically based upon tuition inflation rather than market investment return. Note that over the past twenty years, tuition has generally grown more rapidly than the average market investment return.

b. Currently, three are about eight states that provide a prepaid tuition plan that is accepting new applicants. Those states include Florida, Illinois, Maryland, Massachusetts, Michigan, Nevada, Texas, and Virginia. Prepaid tuition plans are also available through the Independent 529 Plan, which is run by a group of private colleges. In most states, either the account owner or beneficiary must live in the state when the plan is opened. But anyone can contribute to the account.

4. A QTP must provide separate accounting for each account. Code § 529(b)(3). Such accounting must track the account's performance, namely, the earnings that have been accumulated on the investment of contributions. Prop. Treas. Reg. § 1.529-2(f).

C. 529 Plans Are Offered By Each State But Can Be Used In All Other States.

1. Code Section 529 specifies that the Educational Savings Plan, the broadest and most favorable form of 529 Plan, can only be offered by a state, but it can typically be used to meet costs of qualified colleges nationwide. Under most state plans, the student's choice of school is not affected or limited in any way by the state that sponsors the 529 Savings Plan. For example, a parent can be a resident of Massachusetts, invest in a 529 Plan ad mistered by the State of Virginia, and send a child to college at the University of Wisconsin.

2. That said, be aware that while most plans allow investors from out of state, there can be significant state tax advantages and other benefits, such as matching grant and scholarship opportunities, protection from creditors and exemption from state financial aid calculations for investors who invest in a 529 Plan administered by their state of residence.

D. Which States Offer 529 Plans?

1. Virtually every state offers at least one 529 Plan. The 529 Plans differ quite dramatically from state to state, and it is not always easy to compare the different state plans. An investor must research the features and benefits of the available plans before investing. See the article from Money magazine described above for a "ranking" of the best and worst plans.

E. How much can you contribute?

1. To qualify as a 529 plan under federal rules, a state program must not accept contributions in excess of the anticipated cost of a beneficiary's qualified education expenses. At one time, this meant five years of tuition, fees, and room and board at the costliest college under the plan, pursuant to the federal government's "safe harbor" guideline. Now, however, states are interpreting this guideline more broadly, revising their limits to reflect the cost of attending the most expensive schools in the country and including the cost of graduate school. As a result, most states have contribution limits of $300,000 and up (and most states will raise their limits each year to keep up with rising college costs).

2. A state's limit will apply to either kind of 529 plan: prepaid tuition plan or college savings plan (described more fully, below). For a prepaid tuition plan, the state's limit is a limit on the total contributions. For example, if the state's limit is $300,000, you cannot contribute more than $300,000. On the other hand, a college savings plan limits the value of the

account for a beneficiary. When the value of the account (including contributions and investment earnings) reaches the state's limit, no more contributions will be accepted. For example, assume the state's limit is $300,000. If you contribute $250,000 and the account has $50,000 of earnings, you won't be able to contribute anymore--the total value of the account has reached the $300,000 limit.

3. These limits are per beneficiary, so if you and your mother each set up an account for your child in the same plan, your combined contributions can't exceed the plan limit. If you have accounts in more than one state, ask each plan's administrator if contributions to other plans count against the state's maximum. Some plans may also have a contribution limit, both initially and each year.

4. Note: Generally, contribution limits don't cross state lines. Contributions made to one state's 529 plan don't count toward the lifetime contribution limit in another state. But check the rules of your state's plan to find out if that plan takes contributions from other states' plans into consideration when determining if the lifetime contribution limit has been reached.

F. <u>How little can you start off with?</u>

1. Some plans have minimum contribution requirements. This could mean one or more of the following: (1) you have to make a minimum opening deposit when you open your account, (2) each of your contributions has to be at least a certain amount, or (3) you have to contribute at least a certain amount every year. But some plans may waive or lower their minimums (e.g., the opening deposit) if you set up your account for automatic payroll deductions or bank-account debits. Some will also waive fees if you set up such an arrangement. (A growing number of companies are letting their employees contribute to college savings plans via payroll deduction.) Like contribution limits, minimums vary by plan, so be sure to ask your plan administrator.

G. <u>Know your other contribution rules</u>

1. Here are a few other basic rules that apply to most 529 plans:

2. Only cash contributions are accepted (e.g., checks, money orders, credit card payments). You can't contribute stocks, bonds, mutual funds, and the like. If you have money tied up in such assets and would like to invest that money in a 529 plan, you must liquidate the assets first.

3. Contributions may be made by virtually anyone (e.g., your parents, siblings, friends). Just because you're the account owner doesn't mean you're the only one who's allowed to contribute to the account.

4. College savings plans typically offer several different investment portfolios that you can pick from to invest your contributions. If you want to change your investment option, you can generally do so twice per calendar year for your existing contributions, anytime for your future contributions, or anytime you change the beneficiary of the account.

H. Maximizing your contributions

1. Although 529 plans are tax-advantaged vehicles, there's really no way to time your contributions to minimize federal taxes. (If your state offers a generous income tax deduction for contributing to its plan, however, consider contributing as much as possible in your high-income years.) But there may be simple strategies you can use to get the most out of your contributions. For example, investing up to your plan's annual limit every year may help maximize total contributions. Also, a contribution of $15,000 a year or less qualifies for the annual federal gift tax exclusion. And under special rules unique to 529 plans, you can gift a lump sum of up to $75,000 ($150,000 for joint gifts) and avoid federal gift tax, provided you make an election to spread the gift evenly over five years.. This is a valuable strategy if you wish to remove assets from your taxable estate.

I. Lump-sum vs. periodic contributions

1. A common question is whether to fund a 529 plan gradually over time, or with a lump sum. The lump sum would seem to be better because 529 plan earnings grow tax deferred--the sooner you put money in, the sooner you can start to generate earnings. Investing a lump sum may also save you fees over the long run. But the lump sum may have unwanted gift tax consequences, and your opportunities to change an investment portfolio are limited. Gradual investing may let you easily direct future contributions to other portfolios in the plan.

J. Qualified withdrawals are tax free

1. Withdrawals from a 529 plan that are used to pay qualified higher education expenses are completely free from federal income tax and may also be exempt from state income tax. Qualified higher education expenses generally include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an "eligible" educational institution. In addition, the definition includes a limited amount of room-and-board expenses for students attending college on at least a half-time basis. The definition does not currently include the cost of transportation or personal expenses.

2. Starting in 2018, 529 Plans can also be used to pay for private tuition (and ONLY tuition) of up to $10,000 per year for a student to attend grades K through 12.

3. Note: A 529 plan must have a way to make sure that a withdrawal is really used for qualified education expenses. Many plans require that the college be paid directly for education expenses; others will prepay or reimburse the beneficiary for such expenses (receipts or other proof may be required).

K. Beware of nonqualified withdrawals

1. By now, you can probably guess what a nonqualified withdrawal is. Basically, it's any withdrawal that's not used for qualified higher education expenses. For example, if you take money from your account to buy your son a new Porsche, that's a nonqualified withdrawal. Even if you take money out for medical bills or other necessary expenses, you're still making a nonqualified withdrawal.

2. One reason not to make this type of withdrawal is to avoid depleting your college fund. Another compelling reason is that these withdrawals don't enjoy tax-favored treatment. The earnings part of a nonqualified withdrawal will be subject to federal income tax, and the tax will typically be assessed at the account owner's rate, not at the beneficiary's rate. Plus, the earnings part of a nonqualified withdrawal will be subject to a 10 percent federal penalty, and possibly a state penalty too.

L. Is timing withdrawals important?

1. As account owner, you can decide when to withdraw funds from your 529 plan and how much to take out--and there are ways to time your withdrawals for maximum advantage. It's important to coordinate your withdrawals with the education tax credits. That's because the tuition that's used to generate a credit may reduce your available pool of qualified education expenses. A financial aid or tax professional can help you sort this out to ensure that you get the best overall results. It's also a good idea to wait as long as possible to withdraw from the plan. The longer the money stays in the plan, the more time it has to grow tax deferred.

2. Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. As with other investments, there are generally fees and expenses associated with participation in a 529 savings plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated.

M. Tax Issues and Benefits.

1. So long as the plan meets the applicable requirements, federal tax law provides special tax benefits to the plan participant. The benefits include the following:

a. Money contributed to a 529 Plan is in the nature of a gift to the beneficiary, and is not deductible by the donor. The However, earnings from money invested inside the 529 Plan accumulate tax free (similar to an IRA or 401k Plan). Best of all, if the accumulated income is distributed and used for qualified educational expenses, the income is never recognized by the participant or by anyone else.

b. Money from a 529 plan can be used for qualified educational expenses, which includes tuition, fees, books, supplies and equipment required for study at any accredited college, university or vocational school in the United States and at some foreign universities.

c. The money can also be used for room and board, as long as the fund beneficiary is at least a half-time student. Off-campus housing costs are covered up to the allowance for room and board that the college includes in its cost of attendance for federal financial-aid purposes.

d. Qualified education expenses do not include paying student loans and student loan interest.

2. A distribution from a 529 plan that is not used for the above qualified educational expenses is subject to income tax and an additional 10% early-distribution penalty on the gains portion only unless one of the following conditions is satisfied:

a. The designated beneficiary dies, and the distribution goes to another beneficiary or to the estate of the designated beneficiary.

b. The designated beneficiary becomes disabled. A person is considered disabled if there is proof that he or she cannot do any substantial gainful activity because of a physical or mental condition. A physician must determine that the individual's condition can be expected to result in death or continue indefinitely.

c. The designated beneficiary receives any of the following:

i. a qualified scholarship excludable from gross income

ii. Veterans' educational assistance

iii. Employer-provided educational assistance

iv. any other nontaxable payments (other than gifts, bequests or inheritances) received for education expenses

N. <u>Some States (But Not All) Also Offer Tax Incentives To Investors.</u>

1. Although contributions are not deductible by the donor for federal income tax purposes, a significant number of states provide state income tax deductions for all or part of the contributions.

2. There are 30 states that currently allow a deduction for all or a portion of the contribution, including: MA, RI, CT, VT, NY, MD, DC, VA, PA, WV, SC, GA, OH, MI, IN, AL, MS, LA, AR, MO, IA, WI, MN, OK, KS, NE, ND, CO, NM, AZ, UT, MT, ID, and OR.

3. Note that if you claim a state income tax deduction for a contribution and later make a non-qualifying distribution from the 29 Plan, there will be "recapture income" recognized for state income tax purposes.

4. Some states are going to treat distributions for K-12 tuition as triggering a "claw back" of the prior state income tax deduction, including four: IA, NY, OR, and VT. [Quick Political Explanation: These states tend to have very strong teachers unions who oppose private school tuition assistance.]

O. <u>Non-Tax Advantages of Benefits of a 529 Plan.</u>

1. *A huge benefit of a 529 Plan is that the donor maintains full control of the account. With few exceptions, the named beneficiary has no rights to the funds.*

2. Most plans even allow the donor to reclaim the funds at any time. The only consequence of a "non-qualified" withdrawal is that the earnings portion of the account will be subject to income tax plus an additional 10% penalty tax.

3. A 529 plan can provide a very easy hands-off way to save for college. Once the donor decides which 529 plan to use, completes an enrollment form and makes a contribution (or signs up for automatic deposits), the account is thereafter managed by professionals. For better or worse, the ongoing investment of the account is handled by the plan, not by the donor.

4. Plan assets are professionally managed either by the state treasurer's office or by an outside investment company hired as the program manager.

5. The donor will not receive a Form 1099 to report taxable or nontaxable earnings until the year of the withdrawals.

6. If an investment switch is desired, the donor may change to a different option in a 529 savings program every year (program permitting) or the account may be rolled over to a different state's program provided no such rollover for the beneficiary has occurred in the prior 12 months.

7. 529 plans generally have low minimum start-up and contribution requirements. The fees, compared with other investment vehicles, are low, although this depends on the state administering the plan.

8. Everyone is eligible to take advantage of a 529 plan. The amounts that can be contributed to a 529 Plan are substantial (over $300,000 per beneficiary in many state plans). Generally, there are no income limitations or age restrictions.

Joseph B. Darby III

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Joseph B. Darby III is a partner in Sullivan & Worcester's Boston office, focusing his practice on business and transactional tax law. Mr. Darby advises a wide variety of corporations and high-net-worth individuals on tax and legal aspects of business and real estate activities and represents these taxpayers before federal and state taxing authorities. He also works with high-net-worth individuals and business owners to organize their personal income tax and estate planning affairs in order to maximize wealth preservation and minimize tax on transfers to family members, charities and other recipients. This is accomplished through the use of the latest sophisticated estate planning strategies, including family limited partnerships, installment sales to defective grantor trusts, the formation of family charitable foundations, and other similar techniques.

Mr. Darby has represented and advised numerous public and private companies, as well as private equity and venture capital firms, on investment and acquisition transactions and on the disposition of business interests, in transactions ranging from early-stage investments in high-tech startups to acquisitions and sales of mature, late-stage companies and publicly traded corporations.

Another focus in Mr. Darby's practice is the taxation of intellectual property, including tax aspects related to the development, licensing and exploitation of intellectual property rights, the migration of valuable intellectual property to offshore jurisdictions and the tax-efficient sale of intellectual property rights.

Mr. Darby is the author of Practical Guide to Mergers, Acquisitions and Business Sales, Second Edition, a textbook published by *National Underwriter Company*, an ALM (American Legal Media) Business. He has extensive experience in the areas of structuring mergers, acquisitions, business sales, and related business transactions. He teaches graduate-level courses on the buying and selling of businesses at Boston University School of Law in the Graduate Tax Program and at Bentley University McCallum Graduate School of Business in the Masters of Taxation Program.

Practices

- Tax
- Tax Planning for High Net Worth Individuals
- Tax Planning for Business Owners & Investors
- Trusts & Estates
- Public Charities & Private Foundations
- Corporate
- Mergers & Acquisitions
- Intellectual Property
- 1031 Like-Kind Exchanges
- Family Businesses

Bar & Court Admissions

- Massachusetts
- U.S. Tax Court

Education

- J.D., *cum laude*, Harvard Law School, 1978
- B.S., *magna cum laude*, with Department of Honors in Mathematics, University of Illinois at Urbana-Champaign, 1974

Awards & Honors

- *Best Lawyers in America* (2010-2016, 2018)
- *Legal 500 U.S.* (2014, 2015)
- Tax Writer of the Year - 2007 and 2011, *World Trade Executive, Inc.*, a division of Thomson Reuters
- New England Press Association, First Place for Sports Column writing (1990)
- Special Recognition Award from the Armenian Museum and Library of America (1988)
- AV Preeminent®, Martindale-Hubbell® Peer Review Ratings™

SULLIVAN & WORCESTER

Mr. Darby has been the recipient of numerous journalism and writing awards, and has authored two books and more than 1,000 articles published in such diverse publications as *The Tax Lawyer*, *Worth Magazine*, *Venture Capital Magazine*, *Banker & Tradesman*, *Mass High Tech*, *Hemispheres Magazine*, *Contract Professional*, *Trusts & Estates Magazine*, *The Boston Globe*, *The Boston Herald*, *The Boston Business Journal* and *The Boston Phoenix.* Mr. Darby is a frequent contributor to the World Trade Executive family of publications, including *Practical International Tax Strategies*, *Practical European Tax Strategies*, and *Practical US Tax Strategies*, and is a member of the editorial and advisory board of *World Trade Executive*.

Mr. Darby served as a member of the Board of Assessors for the Town of Watertown from 1993-2011, and has served as pro bono legal and tax counsel to a variety of Boston-area charitable organizations. He is a former president of the Boston Police Foundation (2008-2012) and is currently president of the Watertown Police Foundation, an organization he founded in April 2013 to help Watertown recover from the violent events that led to the capture of the Marathon bombing suspects.

Mr. Darby is the editor of the Tax & Sports Update.

Professional & Civic Activities

- Founder and President, Watertown Police Foundation (2013 to present)
- Former President and Member of the Board of Trustees, Boston Police Foundation (2008-2012)
- Member, Board of Assessors, Watertown, Massachusetts (1993-2011)
- Adjunct Professor, Boston University School of Law, Graduate Tax Program (2003 to present)
- Adjunct Professor, Masters in Taxation Program, Bentley University (2007 to present)
- Member of the Advisory Board of *World Trade Executive* for the following publications:
    - *Practical US/International Tax Strategies*
    - *Practical European Tax Strategies*
    - *Practical US/Domestic Tax Strategies*