# I. EDUCATION

A. Education IRAs. Education IRAs are expanded under the 2001 Tax Act effective January 1, 2002. Because of the broad scope of these revisions, the changes are best explained by reexamining Education IRAs (now called Education Savings Plans) in their entirety.

1. In General. Since 1998, Congress allowed a meager $500 maximum per child to annually be deposited into a self-directed tax-deferred savings account called an education individual retirement account ("Education IRA").

Education IRAs are not retirement vehicles. Rather, earnings on deposits are allowed to (i) accumulate tax free and (ii) be distributed tax free provided distributions are used to pay qualified education expenses.

2. Setting Up an Education IRA. Opening an Education IRA is generally as simple as would be the opening of a CUTMA account at a bank or securities firm. An adult opens up an account for a child age 17 or younger and matters contributions to the account. All contributions must be in cash. No portion may be invested in a life insurance contract.

3. Exempt Distributions. Distributions used for qualified higher deduction expenses of the designated beneficiary are excluded from tax.

4. Distributions Not Used for Education. Distributions not used for education received by a beneficiary are taxable to the beneficiary at the beneficiary's tax rate. Non tax-free distributions are deemed paid pro rata from both contributions (which are always tax-free) and earnings (which may be excludible), contributions bear to the total balance of the IRA at the time of the distribution is made.

Because the beneficiary is often in a lower tax bracket, but for the penalty amount (and absent a distribution to the parent), there is a lower tax rate and the burden of the distributions does not fall on the parent setting up the Education IRA.

5. Ten Percent Penalty. Any taxpayer who receives a payment or distribution from an Education IRA that is not tax free is subject to a 10 percent tax on the distribution taxable portion.

6. Exceptions. The 10 percent tax does not apply to distributions:

a. Death. Paid to a deceased designated beneficiary's estate;

b. Disability. Attributable to the designated beneficiary being disabled (as defined under Code Sec. 72(m)(7));

c. Scholarship. Made on account of a scholarship or allowance (as defined under new Code Sec. 25A(g)(2)) received by the account holder to the extent the amount of the distribution does not exceed the amount of the scholarship or allowance; or

d. Excessive. Returning excess contributions and earnings thereon.

7. Disadvantages of the Education IRA. Educations IRAs are useful. Like a regular IRA, there is the right to self-direct investments and earnings are tax deferred. But, Education IRAs have had many disadvantages recognized by Congress.

a. Low Contribution Limit. The $500 maximum annual contribution limit is not indexed for inflation. The $500 limit applies to all accounts funded for the beneficiary that year regardless of who sets it up making it difficult to save enough for college by way of an Education IRA.

b. No Combining Exclusion Incentives. Distributions, even for qualified use, are not tax free during any year that the HOPE credit or the lifetime learning credit is claimed.

c. Phase-Out. The $500 contribution limit phases out for the well-to-do. A husband and wife earning more than $150,000 are subject to the phase-out rule.

d. No Combining Contributions Incentive. A contribution to an Education IRA is subject to an annual 6 percent excise tax penalty if, in the same year, a contribution is made to a qualified state tuition program (see below).

e. Room and Board. Only $2,500 could be spent for room and board expenses off campus.

f. Termination. The Education IRA must terminate when the beneficiary reaches age 30 or upon the death of a designated beneficiary.

8. 2001 Tax Act Changes. The 2001 Tax Act addressed the foregoing concerns and others:

a. Annual Contribution Limit. The 2001 Tax Act increases the annual limit or contributions to education IRAs from $500 to $2,000. By expanding the contribution amount, Congress believed that this program will be more useful to many taxpayers. As before, the $2,000 limit is based on the total amount that may be given by all persons to any one beneficiary within a year.

NOTE: Any contribution to an Education IRA is treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the $10,000 gift tax exclusion under Code Section 2503(b) and are excludible for purposes of the generation-skipping transfer tax.

b. Distributions. Education IRAs, distributions can only be paid to the designated beneficiary named on the account. If distributions are used to pay for "qualified higher education expenses," these distributions are tax free. Previously, these expenses could only be used for higher education (post-high school) at an accredited college, university or vocational school. Qualified Higher Education Expenses include a beneficiary's tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible education institution. Under the 2001 Tax Act, Education IRAs are substantially expanded. Beginning January 1, 2002, Education IRAs may provide distributions for education at all levels of schooling, including elementary and secondary education. The 2001 Tax Act expands the definition of qualified education expenses to include "qualified elementary and secondary school expenses," namely, expenses for: (i) tuition, fees, academic tutoring, special need services, books, supplies, computer equipment (including related software and services), and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12), and (ii) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary.

NOTE: Home schooling programs are specifically contemplated where the program is recognized as providing educational value. Many home school programs rely heavily on the use of computer software for education. Committee reports clarify that computer software involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

c. Married Couple's Contribution Limit Removed. The 2001 Tax Act removes the marriage penalty gradually with respect to the phase-out for married spouses who wish to fund Education IRAs. The 2001 Tax Act increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified adjusted gross income. Thus, the change is as follows:

| Education IRA Phase-Out Range | | |
|---|---|---|
| | 2001 | 2002 |
| Single | $95,000 - 110,000 | $95,000 - 110,000 |
| Married-Joint | $150,000 - 160,000 | $190,000 - 220,000 |

d. Contributions Permitted Until April 15. Previously, contributions to an Education IRA had to be made by December 31 with respect to determining the contribution limit for any year. Under the 2001 Tax Act, individual contributors generally may make contributions for a year until April 15 of the following year. While no deduction is allowed for contributions to an Education IRA, apparently the confusion in the name of this savings plan caused confusion as to the timing of contributions.

e. Coordination with Qualified Tuition Programs. The 2001 Tax Act removes a barrier to Education IRAs by repealing the 6 percent excise tax on contributions to an Education IRA where in the same year on behalf of a beneficiary a contribution is made to a qualified state tuition plan (Section 529 plan). Thus, taxpayers need no longer worry about which program to choose, Education IRAs or Section 529 programs (i.e., ScholarShare). Taxpayers may choose to fund both in the same tax year.

i. Coordination with HOPE and Lifetime Learning Credits. The 2001 Tax Act liberalizes the use of Education IRAs and education credits in the same tax year and allows a taxpayer to claim in the same year both: (i) a HOPE credit or Lifetime Learning credit, and (ii) to exclude from gross income amounts qualifying for distribution from an Education IRA (on behalf of the same student). The only limit is that the Education IRA distribution exclusion may not be claimed on the same educational expenses for which an education credit was claimed. In other words, to claim a credit, either (i) other monies must be used for educational expenses to claim a credit or (ii) if funds come from an education IRA, those funds upon which the credit is claimed cannot be excluded from income.

f. Contribution After Age 18, Termination Age 30. While, generally, it remains true that contributions may not be made after the designated beneficiary reaches age 18, an exception has been created. Under the 2001 Tax Act, the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (to be defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30.

WARNING: Most special needs children will not qualify. Children with high functioning autism, PDDNOS and attention deficit disorder will not qualify if they can timely complete their education. Congress intends that the Treasury will only find a special needs beneficiary to include an individual who, because of a physical, mental, or emotional condition (including learning disability), requires additional time to complete his or her education.

g. Change Beneficiaries. There has been no change to the rule that amounts held in an Education IRA may also be rolled over into another Education IRA for the benefit of the same beneficiary (e.g., to change the investment vehicle). A participant may also change or roll over an Education IRA for a member of the benefi-ciary's family. Provided the rollover occurs within sixty (60) days of the distribution, the amount will not be included in the distributee's gross income. This power to change beneficiaries will not be treated as a retained power causing estate tax inclusion of the Education IRA for estate tax purposes. If a beneficiary's interest is rolled over to another beneficiary or there is a change in beneficiary, no gift or generation-skipping transfer tax consequences result, provided that two beneficiaries are of the same generation. If a beneficiary's interest is rolled over to a beneficiary in a lower generation (e.g., parent to child or aunt to niece), the five-year averaging rule may be applied to exempt up to $50,000 of the transferred amount.

h. Room and Board. Prior to the 2001 Tax Act, qualified higher education expenses also include room and board to the extent of the minimum room and board allowance applicable to the student as determined by the institution or a meager $2,500 for students living off campus. Room and board expenses will be considered qualified higher education costs only if (1) the designated beneficiary is enrolled in a degree, certificate or program leading to a recognized educational credential at an eligible educational institution and (2) the student carries at least one-half the normal, full-time work loan for the course of study pursued.

Under the 2001 Tax Act, it appears that the $2,500 amount will be increased to the amount allowable for student financial aid.

i. Excess Contributions. With the extension to April 15 of the following year for contributions, any excess contribution must be returned by June 1st that later year.

j. Effective Date. All new provisions for education IRAs commence January 1, 2002.

B. State Tuition Programs. A small change has been made to State Tuition Programs which will transfer revenue from states to the federal government.

1. Present Law. Under the 1997 Tax Act, taxpayers may avail themselves of qualified state tuition programs ("Section 529 Program"). Presently many states have adopted programs to provide a tax-favored savings program for college.

a. For example, under the Golden State ScholarShare Trust Act (Chapter 851, Statutes of 1997 (AB 530)), California allowed the implementation of a Section 529 Program released October 4, 1999. The program is co-administered by the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF). ScholarShare is a state-sanctioned savings plan available to all persons, whether or not a California resident. Funds put into ScholarShare may be spent to attend any accredited college or university whether or not located in California.

b. Like an Education IRA, the earnings from the section account accumulate tax free. No tax applies to the earnings before the time of disbursement. If disbursements are used for college education costs, no distributions are taxable as income to the beneficiary.

2. 2001 Tax Act.

a. Penalty. Previously, each state program was required to provide a non-de minimis monetary penalty (typically 10%) on non-qualifying distributions, i.e, not for qualified education. For example, if funds are returned to the parent or used for the child for transportation, the penalty would apply. The funds lost could be retained by the state or redistributed however agreed by the plan.

Under the 2001 Tax Act, beginning after December 31, 2003, the penalty forfeiture is removed and instead an additional 10 percent tax is assessed (and paid to the IRS) on the amount of non-qualifying distributions after December 31, 2003. The effect of this change is that the benefits of the penalty forfeitures are not given to the states or other investors but go to the IRS. There is no longer a requirement that Section 529 accounts provide an administrative forfeiture penalty.

b. Exceptions to Penalty. The same exceptions that apply to non-qualifying distributions from Education IRAs also apply to these programs. (Act § 402.)

c. Parallel Changes to Section 529 Programs. Unlike Education IRAS, Section 529 plans are intended only to provide for higher education (post-secondary education), but other changes conform to Education IRAs or provide technical clarifications, including:

i. Exclusion from Gross Income. Beginning after December 31, 2001, instead of taxing the beneficiary on distributions, a complete exclusion from gross income is provided for qualified distributions from qualified State tuition programs.

ii. Qualified Higher Education Expenses. To be a qualified distribution a distribution must be used to pay for qualified higher education expenses. While the definition remains mostly unchanged (most college expenses qualify), instead of the meager $2,500 allowance for off-campus room and board, the 2001 Tax Act provides that the maximum room and board allowance excluded will equal the amount allowed by the student in calculating costs of attendance for federal financial aid programs under Section 472 of the Higher Education Act of 1965 (as in effect on the date of enactment). In the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board is allowed.

iii. Coordination with HOPE and Lifetime Learning Credits. The 2001 Tax Act will now allow a taxpayer to claim in the same tax year both (i) a HOPE credit or Lifetime Learning credit and (ii) an exclusion from gross income of qualified distributions from a qualified tuition program on behalf of the same student. So long as the distribution is not used for the same expenses for which a credit was claimed, both benefits may be claimed.

iv. Rollovers for Benefit of Same Beneficiary. The 2001 Tax Act clarified that a rollover of tuition credits (or account amounts) out of a qualified state tuition program for the benefit of one designated beneficiary to another qualified tuition program for the benefit of the same beneficiary will not be considered a taxable distribution. This tax-free rollover treatment is allowed only once every three months with respect to the same designated beneficiary.

v. Member of Family. The 2001 Tax Act provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

vi. Special Needs Beneficiary. The definition of qualified higher education expenses is modified to include expenses of a special needs beneficiary which are necessary in connection with his or her enrollment or attendance at the eligible education institution. A special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

d. Private Tuition Programs. While private colleges and educational institutions cannot set up private college savings plans, many have already established prepaid tuition credit programs. Under the 2001 Tax Act, tuition programs are expanded to have Section 529 include private educational institutions after they obtain a ruling or determination that their program meets the requirements. Effective with contributions after 2001 and distributions after 2003.

In order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the private college program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under Section 408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

NOTE: Without this provision, nonconforming private colleges will continue to fall outside of Section 529 for determining the tax treatment of contributions and tuition credits. Tax advisors must review these plans carefully.