State-of-the-Art Educational Giving -- Take Advantage Of the QSTP

If you intend to help pay for your child or grandchild's college education, you probably already know that you can simply pay tuition directly to the college without owing gift tax. The problem with this method is that it doesn't work until the children are college age -- and only if you have the immediate funds. Rather than wait, you could set up trusts for the children's education and make ongoing contributions. But these trusts can be cumbersome. A simpler method of saving for a child's education now exists. Recent federal tax law changes and new state laws have created qualified state tuition programs (QSTPs). These allow you to take advantage of the benefits of early funding for college education while enjoying substantial tax advantages. The result is you can provide more money for education at less cost.

A Beneficial Plan

Many states are now establishing QSTPs (also referred to as Section 529 plans) to allow parents and grandparents to prepay tuition benefits or contribute to an account established for paying higher education expenses. States that quickly foresaw the benefits of these plans have already implemented QSTP programs.

Now states are racing to develop sophisticated programs to implement the changes in federal tax law that allow for improved plans. A tremendous advantage offered by some states' plans is that college location doesn't matter. For example, the plans currently in effect in both New Hampshire and Maine will fund college expenses for out-of-state colleges.

By contributing to a QSTP, you can more completely pay for a child or grandchild's college education. Rather than being limited to tuition, a QSTP can also pay for room and board, fees, books and supplies for students who attend school at least half-time.

The plans contain provisions to help alleviate concerns that the contributions won't be used for their intended purpose. If the designated student doesn't use all of the funds for his or her college education, you may designate another family member as a new beneficiary. Depending on your plan, you may have the right to choose a different beneficiary at any time or even take back your gift, subject to a penalty, perhaps 10%.

Even with all the rights you can retain, the gift to the QSTP is out of your taxable estate and can be exempt from the generation-skipping transfer tax.

Some Limitations

One right you lack is to directly or indirectly control the QSTP's investment. But many of these programs are professionally managed, ameliorating this limitation. Fidelity administers the New Hampshire QSTP and Merrill Lynch administers the Maine QSTP.

Income on funds given to a QSTP is not subject to tax until distributed, making more money available for education. In addition, the tax will be paid at the student's tax rate, which will likely be lower than the donor’s, resulting in additional tax savings. The student may be able to further reduce the tax through the use of the Hope credit or the Lifetime Learning credit.

Take a Closer Look

Even with their limitations and rules, QSTPs provide a unique opportunity to save for college. If you have questions or would like to learn more about QSTPs and other ways to save for college education, please let us know. We would welcome the opportunity to assist you.

A Special Rule

Gifts to a QSTP now qualify for the $10,000 annual gift tax exclusion ($20,000 for a married couple). A special rule applying to QSTPs allows you to make five $10,000 annual exclusion gifts in one year per student for a total contribution of $50,000 ($100,000 for a married couple). This allows you to leverage the use of annual exclusion gifts by making gifts sooner, so that the contribution can appreciate on a tax-deferred basis earlier. The one drawback is that if you die within five years, a portion of the gift would be included in your estate. In addition, the amount you can place in the plan is limited -- you would not be able to make the maximum amount of gifts every five years.