The Michigan Education

How saving for college can be a good investment

Savings Plan

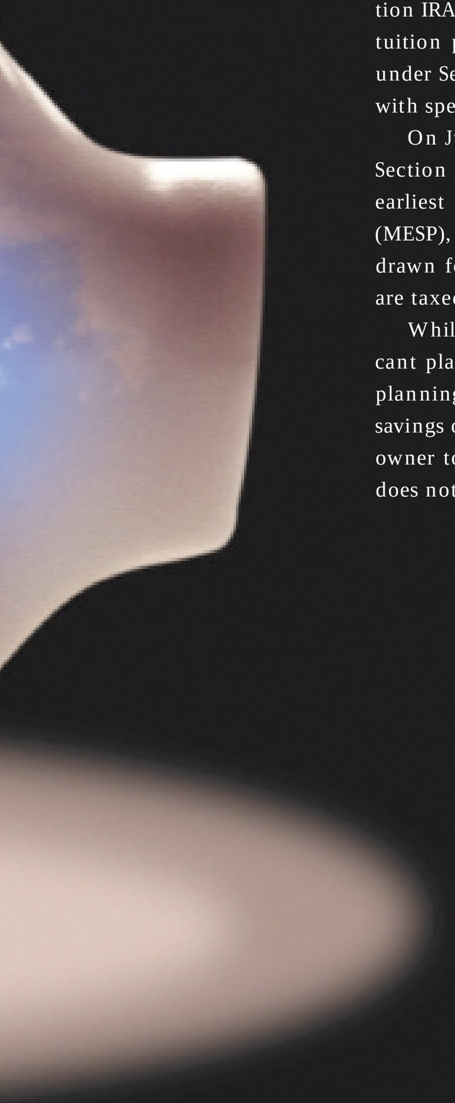
By Ann-Mary Petroskey

The increasingly high costs of post-secondary education have been a concern of parents for many years. College tuition and fees have risen at rates higher than inflation, as evidenced by the latest college board annual survey of tuition and financial aid. The most recent survey found that college tuition and fees rose 4.4 percent at four-year public institutions and 5.2 percent at four-year private colleges, while the rate of inflation, as measured by the Consumer Price Index, rose only 3.4 percent during the same period. Financial aid available to help families to pay for such costs has risen only 74 percent in the past 20 years, while tuition and fees, after adjustments for inflation, have more than doubled. At the same time, family income over the same period has risen only 20 percent.[1]

Fortunately for taxpayers, there are both federal and state tax incentives to provide relief for those seeking to fund these increasing education costs. At the federal level, the Hope and Lifetime Learning Education Credits and education IRAs offer modest relief to taxpayers. In addition, the Internal Revenue Code allows states to offer qualified state tuition programs under Section 529, as will be discussed below. Many states, following the guidelines established under Section 529, now offer qualified plans for either prepaid tuition contracts or tax-deferred savings plans, many with special incentives at the state income tax levels.

On June 16th, 2000, Michigan became a member of the increasingly large group of states offering two types of Section 529 plans by enacting SB 599, 2000 Mich PA 161. In addition to the Michigan Education Trust, one of the earliest state Section 529 prepaid tuition plans, Michigan now offers the Michigan Education Savings Program (MESP), a type of tax-deferred savings plan in which contributions to accounts accumulate tax free until withdrawn for qualified higher education expenses. Once withdrawn for such expenses, the earnings on the account are taxed at the beneficiary's income tax rates, which often will be lower than that of the account owner.

While providing a highly useful tool in funding the expenses of higher education, these plans also offer significant planning opportunities for both income and estate planning. This article will focus on the tax treatment and planning opportunities of MESP plans. An MESP account may provide an investment vehicle that enjoys tax-deferred savings opportunities and removal of account assets from the estate of the account owner, while allowing the account owner to control disposition of the assets. At the same time, establishing an MESP account is relatively simple and does not require complicated trust agreements or tax returns.



Fast Facts

Michigan offers two tax incentive plans to defray the rising cost of tuition: the Michigan Education Trust and the Michigan Education Savings Program (MESP)

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On the Web

www.misaves.com
Michigan Education Savings Plan enrollment information and program details

www.tiaa-cref.org/tuition/index.html
TIAA-CREF (the MESP program manager)
MESP investment and contact information

www.treas.state.mi.us/met/metindex.htm
Michigan Education Trust information and online enrollment form

www.mi-studentaid.org
State of Michigan financial aid website

Qualified State Tuition Programs

Section 529 was added to the Internal Revenue Code by the Small Business Protection Act of 1996. Before then, the law concerning the tax treatment of state-sponsored prepaid tuition programs and education savings programs was unclear. Congress clarified the tax treatment of these programs to encourage savings for post-secondary education expenses. If the state-sponsored program meets the requirements imposed by Section 529, the program is a qualified state tuition program and earnings of the accounts will be exempt from taxation.

A qualified program is one established and maintained by a state agency under which a person may either pre-purchase tuition credits or set aside funds in savings accounts for a beneficiary. In the first type of qualified program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses. The Michigan Education Trust is an example of this type of program. In the second type of qualified program, a person may make contributions to an account established to meet the qualified higher education expenses of the designated beneficiary of the account. The Michigan Education Savings Plan is an example of this type of program.

MESP Accounts

TAXABILITY

The earnings on MESP accounts are deferred for federal and state income tax purposes until withdrawal. When earnings are withdrawn to pay qualified higher education expenses, federal income taxes are paid by the beneficiary (as opposed to the account owner) at the beneficiary's tax rate. The distributions from an MESP account are not subject to state income tax if they are made for qualified higher education expenses and are from a plan sponsored by the state in which the beneficiary resides. To qualify for such tax treatment and to achieve other favorable federal income, estate, gift, and generation-skipping tax treatment, MESP accounts are subject to the restrictions and procedures described below.

CONTRIBUTIONS

Contributions to an account must be made in cash and cannot be made in the form of property. Under the Michigan plan, contributions for any one beneficiary may not exceed a maximum account balance limit of $125,000.

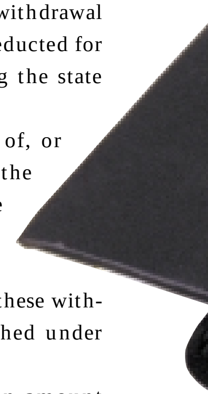
WITHDRAWALS

Only the account owner may direct withdrawals from an account. Withdrawals from an MESP account will be classified as a qualified withdrawal; a nonqualified withdrawal; a withdrawal due to the death or disability of, or scholarship award to, the beneficiary; or a rollover distribution. The tax effects of each type of withdrawal vary depending on the type of withdrawal, and withdrawals may be subject to a penalty tax, as required by the federal statute.

A qualified withdrawal is a withdrawal from an MESP account that is used to pay the qualified higher education expenses of the beneficiary. Such expenses are defined to include only tuition, fees, the cost of books, supplies, and equipment required for the enrollment or attendance of a beneficiary at an eligible educational institution and certain room and board costs if the beneficiary is enrolled with at least a half-time course load. The amount of room and board expenses that are allowed is limited to the amount normally charged for students living in housing that is owned or operated by the school, $2,500 per year for students living off-campus and not at home, or $1,500 for students living at home with a parent or guardian.

The earnings portion of a qualified withdrawal is taken into account when computing the federal income tax liability of the beneficiary. Under Michigan law, no state income tax is due on qualified withdrawals from an MESP account.[2]

A nonqualified withdrawal is any withdrawal from an account other than a qualified withdrawal; a withdrawal because of the death or disability of, or scholarship award to, the beneficiary; or a rollover distribution. Under federal law, a 10 percent penalty on the withdrawal amount applies to all nonqualified withdrawals. Unlike a qualified withdrawal, the earnings portion of a nonqualified withdrawal is taken into account when computing the federal and state income tax liability of the account owner, rather than that of the beneficiary. In addition, the portion of the nonqualified withdrawal that is attributable to contributions that were previously deducted for state income tax purposes will be included in computing the state taxable income of the account owner.[3]



Withdrawals resulting from the death or disability of, or scholarship award to, the beneficiary are not subject to the nonqualified withdrawal penalty described previously. The earnings portion of such withdrawals, however, is taken into account when computing the federal income tax liability of the account owner. No state income tax is due on these withdrawals, provided that they are from an account established under the Michigan plan.

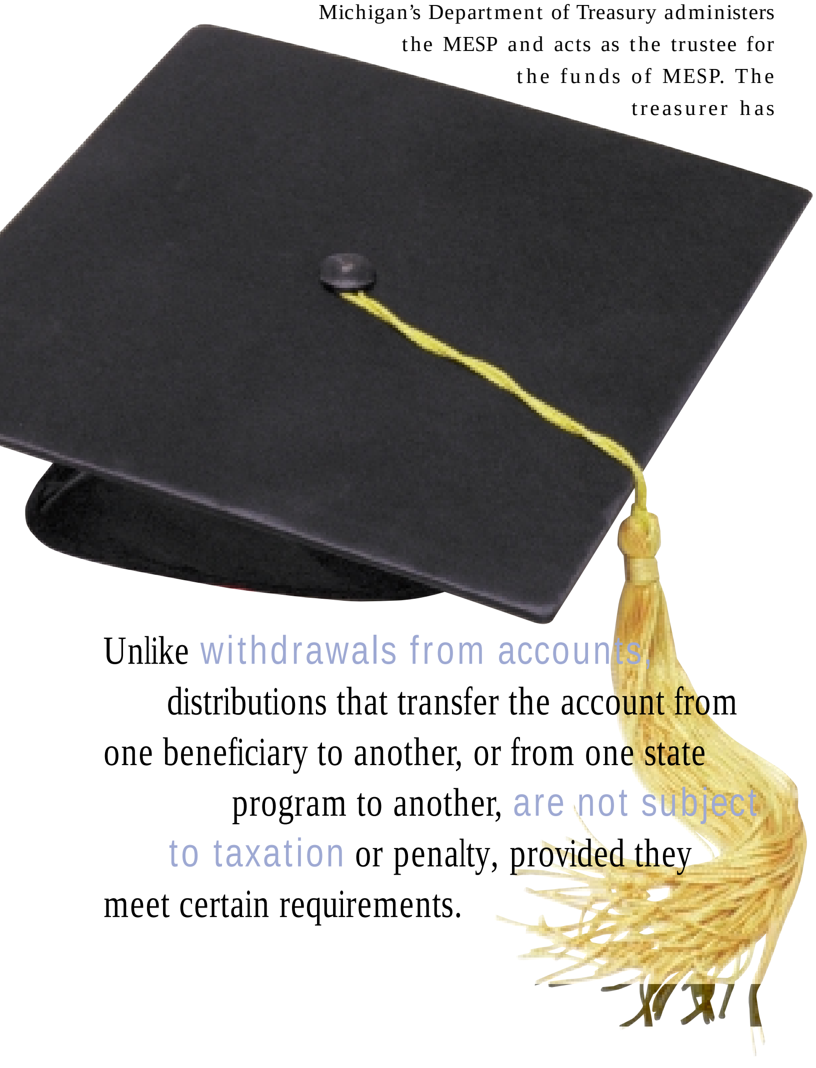
If an educational institution refunds any portion of an amount withdrawn from an MESP account to pay qualified higher education expenses, such amounts will be treated as a nonqualified withdrawal and will be subject to the nonqualified withdrawal penalty. The beneficiary or the account owner is required to provide the program manager with a statement identifying the amount of any such refunds at the end of each year in which they were made and at the end of the next year.

Unlike withdrawals from accounts, distributions that transfer the account from one beneficiary to another, or from one state program to another, are not subject to taxation or penalty, provided they meet certain requirements. These distributions are called rollover distributions. A rollover distribution includes a transaction where, within 60 days of a withdrawal of the funds from an MESP account, the funds are then deposited in another MESP account, or within 60 days of the withdrawal of funds from another state's qualified state tuition program such funds are deposited in an MESP account. Transfers from another state's qualified state tuition program to an MESP account made within the 60-day time limit should also qualify as tax-free rollovers. However, the requirements of the other state's qualified state tuition program may impose restrictions on, or may not allow, such a transfer, depending on the terms of that program.

To qualify for the tax-free rollover, the transfer must be made for the benefit of a different beneficiary who is a member of the family of the prior beneficiary. Under federal law, a member of the family is defined as a person related to the beneficiary as a son or daughter, or a descendant of either; a stepson or stepdaughter; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or step-mother; a son or daughter of a brother or sister; a brother or sister of the father or mother; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or the spouse of any of the foregoing individuals, including the beneficiary. A child includes a legally adopted child and a brother or sister includes a half-brother or half-sister.

MESP Administration and Investment Options

Michigan's Department of Treasury administers the MESP and acts as the trustee for the funds of MESP. The treasurer has engaged TIAA-CREF Tuition Financing, Inc. (TFI) to serve as the program manager. TFI is a wholly owned indirect subsidiary of TIAA-CREF. TIAA-CREF comprises one of the world's largest pension systems, based on assets under management. TIAA-CREF subsidiaries also serve as program managers to various other state qualified tuition programs.



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As the program manager, TFI provides investment management, administration, record keeping, reporting, regulatory, tax reporting, marketing, and outreach and other services for MESP. For its services as program manager, TFI is paid an aggregate management fee, currently at an annual rate of approximately 0.65 percent of the average daily net assets of MESP. Except for the management fee and the nonqualified withdrawal penalty, there is currently no other fee, charge, or penalty imposed in connection with opening or maintaining an account.

There are three available investment options for MESP accounts. These investments are not insured or guaranteed. Investors can allocate contributions to MESP accounts for investment in any one or a combination of the investment options. However, once made, contributions and any earnings thereon may not be transferred to another investment option unless there is a change of the beneficiary of the account or a transfer of funds to an account for a different beneficiary.

The three investment options are the managed allocation option, the 100 percent equity option, and the guaranteed option. Under the managed allocation option, contributions are allocated among five mutual funds. The age of the beneficiary of an account and when that beneficiary is expected to enroll in college determine how contributions are allocated. An account for younger beneficiaries will be weighted toward equity investments. An account for older beneficiaries will be weighted toward fixed income investments.

Under the 100 percent equity option, contributions are allocated between two mutual funds in accordance with the investment policy adopted by the state. The guaranteed option initially allocates contributions to an institutional money market fund. Because of the restrictions imposed by Section 529, account owners and beneficiaries may not direct the investment of any contribution made to an account or any earnings on contributions.

Tax Planning Considerations

When using an MESP account to pay for education costs, individuals will need to consider various factors in income tax planning. There are several benefits available when using MESP funds for education expenses. Subject to applicable restrictions, amounts withdrawn from an account and used to pay qualified higher education expenses of a beneficiary may be available as a credit against the federal income tax liability of that beneficiary, or the person claiming the beneficiary as a dependent, using the HOPE Scholarship credit or Lifetime Learning credit. An additional benefit is that qualified withdrawals are taxed at the beneficiary's income tax rate.

When considering the various tax effects of using an MESP account, the planner should bear in mind that account owners may not contribute to an education IRA for a beneficiary and contribute to a qualified state tuition program account for the same beneficiary in the

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same tax year without penalty. Another planning aspect that must be considered when using an MESP account is determining how it will affect the beneficiary's ability to qualify for need-based financial aid. Because the earnings portion of the withdrawals is taxed to the beneficiary, this may impact the level and type of financial aid available.

Perhaps the most attractive tax planning incentives in using an MESP account are in the federal gift, estate, and generation-skipping transfer tax incentives. Many taxpayers are reluctant to gift away assets to minors, who might then dissipate the funds. Contributions to MESP accounts are considered completed gifts for federal tax purposes. However, the account owner still retains the ability to direct withdrawals, maintaining ultimate control over account funds. Subject to the penalties discussed earlier, the account owner can even direct that the account funds be repaid to the original contributor. For purposes of estate and gift taxes, the account funds are included in the gross estate of the beneficiary, not the account owner. This retention of control over the funds, while removing the funds from the gross estate of the contributor, offers the opportunity for relatively painless estate tax planning from the perspective of the contributor.

The contributions to an MESP account are subject to federal gift tax and are eligible for the annual $10,000 exclusion, or $20,000 for a married individual who elects to split gifts with his or her spouse. As an additional benefit under Section 529, if an account owner's contributions to accounts for a beneficiary in a single year exceed $10,000, the account owner may elect to treat up to $50,000 of the contributions, or $100,000 in the case of a consenting married couple, as having been made ratably over a five-year period. Gift tax returns are still required for gifts in excess of the $10,000 annual exclusion. However, no gift tax will be due unless the gift exceeds the $50,000/$100,000 amount and all lifetime transfer tax exemptions have been used. If contributions are made to the account of a beneficiary who is two or more generations below the account owner, the contributions may also be subject to generation-skipping transfer taxes, subject to the applicable exclusions.

Amounts in an account that were considered completed gifts by the account owner will not be included in the account owner's gross estate for federal estate tax purposes. However, if the account owner elected to treat the gifts as having been made over a five-year period and dies before the end of the five-year period, the portion of the contribution allocable to the remaining years in the five-year period would be includable in computing the account owner's gross estate. Amounts in an account at the death of a beneficiary will be included in the beneficiary's gross estate for federal estate tax purposes.

A possible trap exists when making a rollover distribution. If the rollover is to an account for the benefit of a beneficiary who is of a younger generation than the beneficiary being replaced, the amount rolled over will be subject to gift tax. In addition, if the new beneficiary is two or more generations below the prior beneficiary, the transfer may be subject to the generation-skipping transfer tax. Under proposed regulations, the gift tax and generation-skipping transfer tax are imposed on the prior beneficiary, not the account owner.

Special State Incentives

In addition to enacting the Michigan Education Savings Program, three other pieces of legislation were enacted that are specific to the Michigan program. The Michigan Income Tax Act was amended to make contributions to education savings accounts according to the Michigan Education Savings Program Act after October 1, 2000 deductible to the extent of $5,000 (or $10,000 for a joint return) per tax year, in any year except that in which a withdrawal is made from the account.[4] This deduction is limited to contributions made to the Michigan program only, and excess contributions do not carry over to subsequent years.

The same legislative package provides that distributions that are qualified withdrawals from education savings accounts to a designated beneficiary are to be deducted from state gross income.[5] In a separate piece of legislation, allocations were made for a state matching fund that would provide one dollar of state funds for every three dollars, up to a total of $200, for beneficiaries in the first year that accounts were activated.[6] These matching funds are only available to the beneficiaries of accounts who are under six years of age and from households with incomes of less than $80,000.

Conclusion

While there are significant benefits when using the MESP to plan for education costs, investors and advisors need to be aware of the tax consequences of using the program. Rollover distributions and the possible tax effects of distributions for nonqualified expenses may be a concern once the accounts are established. Those using MESP accounts for estate planning reasons should consult with their tax planning advisor to avoid any unforeseen and potentially significant tax consequences. Final regulations implementing the provisions of Section 529 have not yet been issued and several changes have been suggested on the proposed regulations in effect at this time. When those regulations are issued, there may be additional issues affecting the use of the MESP. ✦

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Footnotes

1. See generally Andrew Browstein, Tuition Rises Faster Than Inflation, and Faster Than in Previous Years, Oct. 27, 2000, Chron. Of Higher Educ.
2. 2000 Mich PA 163.
3. 2000 Mich PA 162.
4. HR 5653, 200 Mich PA 162.
5. HR 5654, 2000 Mich PA 163.
6. SB 600, 2000 Mich PA ____.