Higher Education Financial Assistance Tools for Middle- and Upper-Income Taxpayers

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This article describes higher education financial assistance tools designed mainly for students of middle- and upper-income families who may not be eligible for financial aid from other sources. It includes the 2007 legislative updates for these tools, all of which have been devised and offered by either state or federal governments. The authors discuss the advantages and disadvantages of each tool and offer planning suggestions for families, students, and others who may participate in the higher education financial planning process.

Pursuing higher education has never been inexpensive. The United States has experienced relatively low inflation during the last 25 years; in recent years, however, average increases in college tuition have greatly exceeded the inflation rate and have made it much more difficult for the typical student to earn a college degree. Recognizing the risk posed to an America with fewer college graduates, the U.S. Congress and state legislative bodies have enacted a handful of legislative remedies, all of which are intended to ease the financial burden on Americans who are pursuing or plan to pursue higher education.

The purpose of this article is to explain lesser-known alternatives for higher education financing, to provide the most recent information on alternative financing, and to discuss and offer recommendations regarding alternative financing.

Background

During the past 30 years, college tuition rates have been increasing at two to three times the annual rate of inflation (College Savings Plans Network, CSPN, 2006). Between 1989 and 1999, costs associated with higher education increased 5.6%. This was more than twice the increase in the consumer price index (CPI), which was 2.3% (Bell & Ackerly, 2004). Even as recently as 2005, despite a modest annual CPI increase of 3.4% (Hagenbaugh, 2006), tuition increases for the 2005–2006 school year revealed an average increase of 7.1% at public 4-year institutions and 5.9% at private 4-year institutions (The College Board, 2005). Yet during this same time period, federal-level financial assistance—which was once primarily distributed in the form of grants—shifted toward a greater reliance on student loans. Currently, about 51% of all federal financial assistance is distributed as student loans (The College Board, 2006). As a result of this shift toward student loans, many college graduates are burdened with massive loan debt as they enter the work force (CSPN, 2006).

Before 1997, two popular methods of saving to pay for college tuition were via Uniform Gifts to Minors Act (UGMA) or...
Uniform Transfers to Minors Act (UTMA) accounts and through the redemption of U.S. Savings Bonds (Bell & Ackerly, 2004). However, UGMA and UTMA accounts, according to Peterson and Mintz (2003), offer limited flexibility and are excessively restrictive in their application, terms of investment, and authorized assets. Savings bonds, although low risk, generally return a very low interest rate and do not attain face value until many years after their purchase (Peterson & Mintz, 2003).

In 1997, Congress established an “education individual retirement account” (Education IRA) as part of its Taxpayer Relief Act (Milam & Tuthill, 2001). Other higher education financial assistance programs implemented as a result of the Education IRA included two tax credits: the federal Hope Scholarship Credit and the Lifetime Learning Credit. In addition, with passage of this legislation, interest paid on qualified education loans became deductible (Milam & Tuthill, 2001). However, because of certain restrictions, the Education IRA was of “little significance until passage of the Economic Growth and Tax Relief Reconciliation Act of 2001” (Peterson & Mintz, 2003, p. 47).

In 2001, President George W. Bush signed into law the Economic Growth and Tax Relief Reconciliation Act. The Act renamed the Education IRA the Coverdell Education Savings Account in honor of Georgia Senator Paul Coverdell, a longtime supporter of such programs (Damato, 2004), and expanded the definition of a “qualified tuition plan” under Section 529 of the Internal Revenue Code (Section 529 Plan). These two programs, and others providing assistance with the costs associated with higher education, offer students and parents today a variety of options to ease the burden of today’s and the future’s cost of higher education.

Coverdell Education Savings Accounts

Sometimes referred to as a “530 program” (after the Internal Revenue Code section in which it was implemented), the Coverdell Education Savings Account (Coverdell) is in some ways similar to an IRA and, in fact, replaced the earlier Education IRA (Lechner, McClain, & Spero, 2003). For each future college student (often referred to as the “beneficiary”), after-tax contributions of up to $2,000 per year may be deposited into a trust account. Contributions are allowed to compound and grow tax-free within the account (Hulse & Harden, 2003). Tax-free distributions from the account can be used to pay for the beneficiary’s “qualified education expenses.” Coverdell accounts provide a higher degree of flexibility than Section 529 Plans (see below); the individual who opened the account can direct the investment of Coverdell contributions (Lechner et al., 2003).

Coverdell qualified educational expenses include tuition, fees, books, tutoring, services for special-needs students, supplies, computer hardware and software, Internet access, uniforms, transportation, and room and board (Laffie, 2003).
In addition, Coverdell accounts may be used for education expenses in elementary and secondary schools, including private and religious schools. Anyone may contribute to a beneficiary’s Coverdell account and to the beneficiary’s other qualified tuition plans in the same year. The beneficiary of a Coverdell can be changed as long as the new beneficiary is a member of the prior beneficiary’s family—or, if desired, the account contents can be rolled into a Section 529 Plan (Hulse & Harden, 2003). Although the person who establishes a Coverdell account on behalf of a beneficiary is referred to as the “responsible person,” he or she cannot withdraw funds because the account is owned by the beneficiary (Dynarski, 2004). The Coverdell account program was reauthorized by Congress and made a permanent higher education program (Pension Protection Act of 2006). Because uncertainty in the future of the program has been eliminated, more savers may turn to the Coverdell account as a viable savings option.

Qualified Tuition Plans (Section 529 Plans)
Qualified tuition plans (QTP), often referred to as Section 529 Plans, have their origins in prepaid tuition plans first offered by Massachusetts in 1982 and Michigan in 1986. Originally created by the states, these plans are authorized by federal statute and have been available since 1996. When they were first offered, QTPs had a number of restrictions that limited their usefulness (Lechner et al., 2003).

Prepaid tuition plans guarantee that share purchasers’ investments will pay for the tuition costs for a specific number of semesters at state public universities and colleges or, in the Massachusetts plan, at public and participating independent institutions. The rates of return on prepaid tuition programs are tied to the increases in tuition costs; parents and other contributors are thus insured against the risk of rising tuition rates. Michigan exempted investment returns from state income taxes and even challenged the IRS that these funds should also be exempted from federal income taxes. The IRS, however, disagreed; in 1994, Michigan sued the agency and won the case (Dynarski, 2004).

In 1997, Congress codified the tax-exempt status of the prepaid tuition plans in Internal Revenue Code Section 529. Section 529 also recognized and codified a permutation of the prepaid tuition plan, the “tax-advantaged college savings plan,” which had been implemented earlier in a handful of states. This plan enables after-tax investments to compound in accounts free of federal and state taxes, similar to Coverdell accounts (Dynarski, 2004). Section 529 Plans permit the deposit of cash in a specially designated account, the sole purpose of which is to fund the higher education of a designated account beneficiary (Lechner et al., 2003). As with Coverdell accounts, Section 529 Plan distributions are tax-free as long as they are
used for qualified education expenses (QEE). The definition of QEE for these plans, however, is not as broad as with Coverdell accounts (see Table 1).

The Economic Growth and Tax Relief Reconciliation Act of 2001 expanded the definition of a QTP. Eligible educational institutions and state agencies are now permitted to establish prepaid tuition or college savings plans—as long as they follow certain rules (Hulse & Harden, 2003).

All 50 states and the District of Columbia offer these plans in one or both forms (Armstrong & Preysnar, 2003). Most states’ plans are open to residents of other states. Private institutions may also establish prepaid tuition plans now but, due to provisions in the Act, are not permitted to offer college savings plans. Currently, more than 260 private colleges offer prepaid tuition plans (Independent 529 Plan, n.d.).

**Education Savings Bonds**

Education savings bonds are a less complex alternative to Section 529 Plan and Coverdell accounts. Series EE bonds issued on or after January 1, 1990, and Series I bonds qualify to assist with higher education costs. The individual purchasing the bonds to address future education expenses of a beneficiary must be 24 years old on the first day of the month in which the bonds are purchased (Adkins & Henderson, 2004). Maximum adjusted gross income (AGI) limits apply to the use of savings bonds (Internal Revenue Service, IRS, 2006).

**Traditional and Roth Individual Retirement Accounts (IRAs)**

With most IRAs, distributions taken before the account owner reaches age 59½ incur a 10% early withdrawal penalty, in addition to regular income tax on distributed earnings or deductible contributions (Adkins & Henderson, 2004). However, when used for qualified education expenses of the IRA holder, spouse, child or grandchild, the early withdrawal penalty does not apply. QEE includes tuition and fees, books, supplies, and equipment, and expenses for special needs students; the definition excludes room and board unless the student is enrolled at least half time (Lechner et al., 2003).

**Hope Scholarship Credit**

Implemented as part of the Taxpayer Relief Act of 1997 and delineated in Internal Revenue Code Section 25A, the Hope Scholarship Credit functions as a direct federal government reimbursement to fund a portion of a student’s higher education (Lechner et al., 2003). The tax credit is applicable only to the student’s first 2 years of college and is limited to 100% of the first $1,100 QEE plus 50% of the next $1,100 QEE for a maximum annual credit of $1,650 (IRS, 2006). There is no limit to the number of dependents who can use this credit (Adkins & Henderson, 2004).

The Hope Scholarship Credit definition of QEE includes tuition and enrollment fees paid by the taxpayer; room and board...
### Table 1
Comparison of Coverdell and 529 Savings Plan Accounts

<table>
<thead>
<tr>
<th>Feature</th>
<th>Coverdell</th>
<th>529 Savings Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the annual contribution limit?</td>
<td>$2,000 per beneficiary account per year</td>
<td>$12,000 per beneficiary each year by each parent without triggering the gift tax</td>
</tr>
<tr>
<td></td>
<td>More than one account can be set up in the beneficiary’s name, but the maximum amount per donor per year is $2,000</td>
<td>Extended family members also can donate up to $12,000 per year</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Each state has its own lifetime contribution limit per beneficiary</td>
</tr>
<tr>
<td>Who can contribute?</td>
<td>Anyone</td>
<td>Anyone</td>
</tr>
<tr>
<td>What are some of the tax advantages and disadvantages?</td>
<td>After-tax dollars grow tax-free and qualified withdrawals are tax-free</td>
<td>After-tax dollars grow tax-free and qualified withdrawals are tax-free</td>
</tr>
<tr>
<td></td>
<td>Withdrawals not used for QEE are subject to tax and 10% penalty</td>
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</tr>
<tr>
<td></td>
<td>The account is treated as parents’ asset for financial purposes; may reduce aid eligibility</td>
<td>The account is treated as parents’ asset for financial aid purposes; may reduce aid eligibility</td>
</tr>
<tr>
<td></td>
<td>Contributions to the account are not tax-deductible</td>
<td>Contributions to the account are not tax-deductible</td>
</tr>
<tr>
<td>What does the plan consider QEE?</td>
<td>K–12, undergraduate, and graduate:</td>
<td>Undergraduate and graduate:</td>
</tr>
<tr>
<td></td>
<td>Tuition and fees</td>
<td>Tuition and fees</td>
</tr>
<tr>
<td></td>
<td>Books and supplies</td>
<td>Books and supplies</td>
</tr>
<tr>
<td></td>
<td>Hardware and software</td>
<td>Equipment required for enrollment or attendance</td>
</tr>
<tr>
<td></td>
<td>Special needs student expenses</td>
<td>Special needs student expenses</td>
</tr>
<tr>
<td></td>
<td>Tutoring</td>
<td>Room and board (if at least half-time)</td>
</tr>
<tr>
<td></td>
<td>Uniforms</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Transportation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Internet access</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Room and board (if at least half-time)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Payments to a 529 plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Some supplementary services</td>
<td></td>
</tr>
<tr>
<td>What are the age restrictions regarding contributions to the account?</td>
<td>Contributions can be made up to the beneficiary’s 18th birthday</td>
<td>No age restrictions</td>
</tr>
<tr>
<td></td>
<td>The account must be depleted by the beneficiary’s 30th birthday (except for some special needs students)</td>
<td></td>
</tr>
<tr>
<td>Are there rollover provisions?</td>
<td>Same as 529 Plan, except if the account is not used by age 30 it can be rolled over to a Coverdell account for a family member of the beneficiary</td>
<td>Allowed annually from a designated beneficiary to another related family member</td>
</tr>
<tr>
<td></td>
<td>Allowed from one QTP to another QTP</td>
<td></td>
</tr>
<tr>
<td>Who decides where the funds are invested?</td>
<td>Donor determines investment options</td>
<td>State determines investment options</td>
</tr>
<tr>
<td></td>
<td>Accounts are usually managed by an investment firm on behalf of the state</td>
<td></td>
</tr>
<tr>
<td>Who controls the account?</td>
<td>The beneficiary is considered the owner</td>
<td>The owner, usually a parent, grandparent, or other relative, retains control of the account and can withdraw funds at any time subject to tax and penalties</td>
</tr>
<tr>
<td></td>
<td>The person who established the account, although able to change beneficiaries, can never withdraw funds</td>
<td></td>
</tr>
</tbody>
</table>

*Note. QEE = qualified educational expenses; QTP = qualified tuition plan.*
are excluded. Increased for 2007, applicable modified adjusted gross income (MAGI) limits are $57,000 for single filers and $114,000 for joint filers. Persons with felony convictions for possessing or dealing controlled substances are ineligible to claim the Hope Scholarship Credit (Lechner et al., 2003).

**Lifetime Learning Credit**

The Lifetime Learning Credit (LLC) has its roots in the same Internal Revenue Code section as the Hope Scholarship Credit. A taxpayer, his or her spouse, or dependent can claim a tax credit of 20% of the total amount spent on QEE (to a maximum QEE amount of $10,000 per year), for a potential annual $2,000 tax credit (Savingforcollege.com, n.d.-a). MAGI limits are the same as those of the Hope Scholarship Credit. The felony controlled substances conviction rule does not apply. Lechner et al. (2003) call the LLC “...a kind of permanent government subsidy of postsecondary education” (p. 61).

**Employer-Provided Educational Assistance**

This program is uncomplicated and, after many years of surviving year-to-year legislative extension, was finally made permanent by Congress in 2001 (Lechner et al., 2003). If an employer establishes such a program, up to $5,250 of undergraduate or graduate education tuition costs can be reimbursed to or paid on behalf of an employee with no tax liability to the employee.

**Student Loan Interest Deduction**

The student loan interest deduction is an “above-the-line” adjustment that reduces AGI. The taxpayer does not need to itemize to obtain a deduction for interest expense (up to $2,500 per year) on eligible student loans borrowed to pay for tuition, enrollment fees, room and board, books, supplies, equipment, and other necessary expenses, including transportation (Adkins & Henderson, 2004).

**Tuition and Fees Deduction**

A taxpayer, his or her spouse, or dependent can take an above-the-line tuition and fees deduction, part of the Economic Growth and Tax Relief Reconciliation Act of 2001, for tuition and related expenses (Savingforcollege.com, n.d.-a). The taxpayer’s MAGI and filing status determine the amount of the deduction, which may be as much as $4,000 or $2,000 per year.

**Coverdell Education Savings Accounts**

There are several limitations to Coverdell accounts. First, contributions must be made in cash (as opposed to stocks or other assets) and no later than the beneficiary’s 18th birthday; yearly contributions are not tax-deductible. Unless the student has special needs, the account must be totally disbursed by the time the beneficiary reaches age 30. Along with the yearly contribution limit of $2,000, Coverdell participation is limited to single tax filers whose MAGI is less than $110,000 and joint filers whose...
MAGI does not exceed $220,000. Although certain contributors may be disallowed because of these income restrictions, Karl, Petronio, and Wallis (2006) point out that a Coverdell account may be established for a child after he or she receives a cash gift from an income-ineligible parent. Distributions from a Coverdell account, when used for purposes other than QEE, incur both tax and a 10% penalty (Hulse & Harden, 2003). Although Coverdell accounts in their current form were scheduled to expire at the end of 2010, the Pension Protection Act of 2006 made the program permanent (Savingforcollege.com, n.d.-b).

**Qualified Tuition Plans (Section 529 Plans)**

Unlike Coverdell accounts, neither the contributor nor the beneficiary has any control over the investment of Section 529 Plan accounts. Unlike Coverdell accounts, although some plans allow selection of a specific fund from several that are offered (Adkins & Henderson, 2004). The Section 529 Plan QEE definition is also more restrictive than that for Coverdell accounts; the choice of schools that the beneficiary is allowed to attend is also limited (AuWerter, n.d.). Total contributions to the plan are limited by actuarial estimates to the total amount “necessary to pay the beneficiary’s tuition, required fees, and room and board expenses for five years of undergraduate enrollment at the highest cost institution allowed by the QTP” (Bell & Ackerly, 2004, p. 31). Fund management fees, according to Dynarski (2004), also appear to be higher than those of other investment vehicles, such as retail mutual funds, IRAs, or Coverdell accounts.

The theory behind both plans is simple: by investing after-tax dollars into one of the plans, accrued earnings are not taxed upon withdrawal as long as they are used for defined educational purposes. Coverdell and 529 Plans are attractive because:

- The investment is not subject to tax penalties unless it withdrawn and used for a non-education expense.
- Plans can be started as early as the birth of a future student for optimal investment opportunities. In the case of Section 529 Plans, contributions can be made by anyone at any time with a generous maximum amount that can be contributed (subject to certain limitations).
- A Section 529 Plan and a Coverdell account can be started simultaneously, providing contributors a choice of investment opportunities as long as certain limitations are met.

Disadvantages of the plans include the following.

- Coverdell and Section 529 Plan accounts owned by a dependent student’s parents or by an independent student are treated as investment assets and may decrease the amount of federal financial aid by increasing the expected family contribution (The College Board, n.d.).
- Both plans are poorly coordinated with the federal financial aid system and as a result have a tendency to reduce the
Both the Section 529 Plans and Coverdell accounts are somewhat risky investments for parents; it is possible that children for whom the accounts are established may not attend college.
The Coverdell and Section 529 Plans have been in existence for a relatively short time, so the literature provides little anecdotal or statistical evidence on the education-related impact of these programs from their inception to the present. Because of the limited amount of retrospective data, in-depth analyses of the plans' results are nearly impossible. One can speculate on and dissect the inner workings of each plan and attempt to predict how likely, if at all, each plan will fulfill the objectives of those who crafted the legislation. In 2003, Olivas closely examined the Section 529 Plans and found that managers of the plans have "shown little concern for evaluating their results or for conducting research on their portfolios." He also found very little self-critique by the states on behalf of their plans.

Each plan is tweaked and fine-tuned from time to time as unintended consequences and shortfalls manifest themselves. Virtually no peer-reviewed manuscripts exist examining the efficacy of these plans, except for a few articles that describe the plans themselves and address nuances that are beyond the scope of this report; therefore, success of these programs cannot be fully determined. As the result of legislation, the programs are being constantly refined; this tweaking may change program details from year to year.

Education Savings Bonds
The advantage of this savings vehicle, according to Lechner et al. (2003), is flexibility: unlike the Section 529 Plans and Coverdell accounts, purchasers do not have to designate the bonds as intended for education expenses upon purchase. Additionally, there is no requirement that bond proceeds be used for higher education in the future. If bonds are later cashed and used for QEE (limited to tuition and fees and contributions to a Section 529 Plan or Coverdell account), the interest earned will be tax-free as long as the taxpayer does not exceed maximum MAGI limitations. No penalty is assessed if the bonds are used for other purposes; only the interest is taxed. A qualified beneficiary may also take the Hope Scholarship Credit or LLC when using bond proceeds to pay for QEE (Lechner et al., 2003).

Savings bonds also have several limitations. The bonds must be registered in the names of the parents; the child for whom the bonds are purchased can only be named a beneficiary and not a co-owner.

Traditional and Roth IRAs
As noted earlier, a number of advantages exist for using early distribution of IRAs for QEE. Early withdrawal penalties are
waived; however, depending upon the type of IRA, taxes may be still assessed on the withdrawals. When a student attends at least half time, QEE definitions are fairly broad. Hulse and Harden (2003) consider withdrawals from IRAs an option of last resort because of potential damage to the account holder’s retirement goals.

Hope Scholarship Credit and the Lifetime Learning Credit
The Hope Scholarship Credit is limited to students who are in their first 2 years of postsecondary education and enrolled in a program that leads to a degree or other “recognized education credential” (Lechner et al., 2003). The LLC has fewer limitations than the Hope Scholarship Credit; it can be claimed during any year of a student’s postsecondary education, including graduate level, and there is no maximum number of years that it can be claimed. In addition, a student is not required to attend at least half time or even be pursuing a degree to be eligible for the LLC.

Both credits reduce the amount of tax owed dollar-for-dollar; however, neither may be used to generate a refund if the taxpayer owes nothing. A parent cannot claim either credit for a student claimed as a dependent on another person’s tax return. As described earlier, both Hope Scholarship Credit and LLC have MAGI limits, and QEE is limited to tuition and fees. QEE paid for with other tax-free funds do not qualify for either credit. Only one of the two credits may be taken in any year for the same student, and only one LLC may be claimed per tax return per year. However, the Hope Scholarship Credit can be claimed for one student and the Lifetime Learning Credit for another student in the same year (IRS, 2006). A sound strategy, then, is to use the Hope Scholarship Credit for the first two years of school and the LLC for the final two years and beyond (Lechner et al., 2003).

Employer-Paid Educational Assistance
The only limitation to this program is that no employer is required to offer such assistance. QEE is limited to tuition, fees, books, supplies, and equipment. Courses do not have to be work-related and can be at the undergraduate or graduate level. If the benefit exceeds $5,250, the excess amount is taxable to the employee and is usually included in the W-2 Form as wages, tips, and other compensation. Additional rules apply if the assistance is regarded as a “working condition fringe benefit” (IRS, 2006).

Student Loan Interest Deduction
This deduction is limited to the taxpayer, his or her spouse, and dependents. MAGI limits also apply: $65,000 if single and $135,000 if filing jointly. The student for whom the deduction is claimed must be enrolled at least half time in a degree program (IRS, 2006).
Tuition and Fees Deduction
The MAGI limits to claim this deduction are $80,000 if filing single and $160,000 if filing jointly. The deduction can be taken on behalf of the taxpayer, his or her spouse, and dependents. The taxpayer is not permitted to claim an education credit, such as the Hope Scholarship Credit or LLC, for the same student (IRS, 2006).

Recommendations
There are a number of financial assistance programs available to parents of students who want to pursue postsecondary education. Yet access to the programs may sometimes be thwarted by obstacles such as complexity of the application process, income restrictions, and lack of publicity. Most financial aid programs are targeted to lower income families and are fairly well publicized; others, targeted to middle- and high-income families (though not intentionally excluding low-income families), are not publicized early enough in the college planning phase to be as useful as they might be. To address these problems in the financial aid application process, the U.S. Department of Education (2005) published recommendations designed to assist parents and students seeking financial aid, regardless of income level:
(1) Simplify and clarify the Free Application for Federal Student Aid and the income verification process. Several governmental agencies already collect the same data items that are used in financial aid determination.
(2) Improve the federal need analysis process so that the treatment of student earnings and college savings plans do not unfairly penalize or reduce aid eligibility.
(3) Begin the financial planning process earlier in the academic career of the student. Publicize the plans so that parents learn of these alternatives while their children are still very young. Encourage parents to start saving in a Coverdell account or Section 529 Plan or similar investment plans—ideally before the student begins elementary school, but definitely before the beginning of middle school.

Conclusion
It is no secret that financing higher education, regardless of the type of institution, requires long-term planning, patience, sacrifice, and perseverance. Most governmental need-based aid is targeted to students of families with lesser means; many alternative higher education financial tools exist that can be beneficial to middle- and upper-income families and students. Virtually every American has the opportunity to pursue postsecondary education at some level; this is a testament to the importance that we place on higher education as society’s great equalizer. Too many Americans, both young and old, are unaware of available higher education financial assistance tools. For example, 56% of parents are unaware of the existence of Section 529 savings plans (“529 Plan Industry Debates,” 2007). This lack of awareness may be the result of poor program and
plan promotion, lack of ambition on the part of families and future students to investigate options, unfamiliarity with the details of the programs and plans, or other reasons. Because of the Internet, however, information regarding available financial assistance is easier to access than ever before. Programs and plans are available to those seeking help with the ever-increasing costs associated with higher education. Anyone planning for or advising on financial resources for a future college student must become familiar with the options and take advantage of society’s traditionally favorable support for providing the opportunity of higher education for all.

References


