

ALASKA QUALIFIED TUITION PLANS

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In February, Morningstar rated the Alaska Qualified Tuition Plan as among the top five in the nation. This rating is on investment costs and performance. In January the Treasury Department's revenue proposals contained in the Fiscal Year 2005 budget called for significant modification of the laws governing qualified tuition plans (QTPs). The modifications would reduce the flexibility available under current law. If the proposals are enacted as law, existing plans would be grandfathered.

These two unrelated developments are a reminder that the Alaska QTP is an important financial and estate planning tool which should be considered for use sooner rather than later.

QTPs got their real start with federal legislation in 1996. QTPs allow the creation of accounts sponsored by states or eligible educational institutions where invested funds are held on an income tax deferred basis (just like IRAs and qualified retirement plans) until withdrawal. The person who creates the account must designate an account holder and a beneficiary. The creator of the account, the account holder and the beneficiary may be the same person. As a normal practice the account holder is the person contributing the funds and the beneficiary is a child or grandchild of the account holder. Under the Alaska plan contributions can continue to be made to the account until it reaches \$250,000.

The account holder has complete control over the distribution of funds. If the funds are distributed to a beneficiary and are used for qualified education expenses at an eligible education institution there is no income tax due. Qualified educational expenses include tuition, mandatory fees, books, supplies, and required equipment. Room and board may also be a qualified expense. The income portion of distributions which are not used for qualified educational expenses are subject to income taxation plus a 10% of the earnings penalty.

A QTP also offers significant estate and gift tax benefits. The transfer to a QTP is a completed gift to the designated beneficiary. The gift is deemed complete despite the fact that the account holder can reacquire the funds at any time (subject to payment of tax and penalty) or transfer the investment to other members of the beneficiary's family including him or herself (without income tax consequences) by merely changing the beneficiary. The QTP assets are generally not included in the account holder's estate for estate tax purposes.

Moreover, an election can be made to have a single gift treated as if made in five annual installments. In other words instead of being limited by the current annual gift tax exclusion of \$11,000 per donee, a gift of \$55,000 (\$110,000 for a married couple) can be made in a single year and credited against five years of annual exclusions. The

change of beneficiary within the family is a taxable transfer for gift tax purposes only if the new beneficiary is assigned to a lower generation than the old beneficiary.

The account holders may change beneficiaries and even make distributions to themselves. If distributions are applied to qualified educational expenses then no income tax is due. If the account holder or the beneficiary uses the funds for some other purpose then the applicable earnings are subject to income taxation at the recipient's tax rate plus a 10% penalty.

Despite all this the Alaska QTP is exempt from the claims of creditors of the account holder or the beneficiary. AS 14.40.802(h). Moreover, the arrangement is conclusively presumed to be a spendthrift trust, is not subject to involuntary transfer or alienation, and is not considered an asset or property of either the account holder or the beneficiary. Even though maintaining significant control, account assets should be free from the claims of creditors. The creditor protection available under the Alaska QTP is generally considered superior to that of other states.

Keep in mind that QTPs are best viewed as investment vehicles. You are investing cash in financial markets and when the money is withdrawn it may be used for qualified educational expenses at any qualified institution of higher education. Investment in the Alaska plan does not lock you in to education in the Alaska system and the money can be spent at any qualified educational institution.

The Treasury Department proposal would have a significant impact on the design and use of QTPs. Under current law there is no age limit for the beneficiary of a QTP. Thus assets can be held in a tax-deferred environment long beyond the beneficiary's normal college age. In fact some people establish QTPs with the intent of setting up a creditor protected post-retirement nest egg for possible use in funding personal education.

The Treasury Department proposal would require mandatory distribution when the beneficiary reaches 35. In addition the proposal would increase the penalty on non-education distributions to 35% of the amount of distributions between \$50,000 and \$100,000 and 50% on distributions above \$100,000. Unlike the 10% penalty on the earnings which would still apply to the first \$50,000 of non-education distribution, the next two levels of penalty would apply to the entire distribution (not just earnings). This proposed punitive penalty system is intended to dissuade account holders from making significant non-education distributions.

Even more significantly, the proposal would limit the control of the accounts currently enjoyed by the account holder. Under the proposal the account holder would be subject to the duties of a custodian and have an obligation to act on behalf of the designated beneficiary. This would effectively remove the donor's ability to revoke contributions.

While it is a long way from a Treasury Department proposal to tax legislation, this is a proposal that must be watched. The proposal would grandfather QTPs in existence as of the date the legislation is enacted.

This potential for change makes it even more important for individuals to consider QTPs as part of their overall financial and estate planning.

For additional information on the Alaska Qualified Tuition Plan go to www.uacollegesavings.com. Another excellent resource for evaluation of QTPs is www.savingforcollege.com.