TAXATION OF PRE-PAID TUTION PLANS AND OTHER FORMS OF COLLEGE EXPENSE HELP

IHELG Monograph

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$5.00
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I. INTRODUCTION

About three years ago I wrote an article entitled "Financing A College Education: A Taxing Dilemma" for The Ohio State University, College of Law's Law Journal. In the article I attempted to outline the tax consequences of the efforts being made by both the federal government and various state governments to help us defray the cost of sending our children to college. Since that time, much has happened and at the same time, little has changed. In my conclusion of that article I stated that preparation for future college attendance was in fact three-fold. First, the child must study hard. Second, the family must explore may variables, such as curriculum, faculty, placement, social life, reputation and cost to determine which universities are the right ones for their child. Finally, the financing of this choice becomes an important issue. In fact, with the rising cost of college expenses, this issue must be addressed by many parents, well before addressing either of the other two concerns. In planning for financing the college education, much has been proposed. More states have enacted some form of college expense assistance. The federal government has toyed with several approaches to assist parents and students with their higher
education plans and the private sector, by way of banks, insurance companies, brokerage houses and employers have devised methods to help us meet these rising costs.

All of the different programs have two things in common. First, they all involve some sort of future planning, purchase or payment. For most of us, the days of just paying the college expenses out of current earnings while our child is actually going to college is over. In addition, just putting the money in a bank and watching it slowly grow will leave us very short at the needed time. Therefore all of these efforts can be classified as post-secondary savings plans of some sort. Second, all the programs involve some form of tax analysis that must be made to truly get a picture of the cost and benefit of each program. This paper will explore that second concern with the hope of helping to make this process a little less intimidating.

II. THE FEDERAL GOVERNMENT

One of the real sad omissions in the quest to help parents financially plan for their children's future college education rests with the federal government. With the exception of a very limited savings bond program, little, to nothing, positive has come from the federal arena. In fact, with the inclusion of part of a student's scholarship into gross income and the non-deductible interest on student loans, the federal government has actually acted against the interest of higher education. However, some effort is being made to correct this.
A. U.S. SAVINGS BOND PROGRAM

Presently Section 135 of the Internal Revenue Code (hereinafter called "the Code"), provides a limited amount of financial relief to taxpayers for their children's college education. Section 135, entitled "INCOME FROM UNITED STATES SAVINGS BONDS USED TO PAY HIGHER EDUCATION TUITION AND FEES" allows a purchaser of qualified savings bonds to avoid taxation on the redemption of the bonds, if the proceeds are used to pay qualified higher education expenses. In essence, this would allow a person who has a $100 savings bond, which they purchased for $50, to cash the bond in, receive the $100, pay education expenses and not report the $50 of gain on their tax return. Therefore, the gain, or the earnings on the bond, would be tax-free if used for educational purposes. If the taxpayer only used $90 of the $100 received on redemption of the bond for educational expenses, then only $40 of the $50 gain would be tax-free, while the remaining $10 would be taxable.

On the surface, this savings bond approach appears to be very helpful in allowing parents to save for future college costs. Certainly a system by which your investments grow tax-free and allows you the opportunity do cash them in without a taxing event is a system that could go a long way in assisting with the financing of ones college education. However, upon closer review the savings bond program has certain limitations that make it less valuable. First, the bonds eligible for this special treatment are only U.S. Savings Bonds that were issued
after December 31, 1989, therefore excluding from the special treatment of Section 135, all savings bonds purchased prior to that date. Second, the only expenses that fit under the provision are those expenses that are "qualified higher education expenses." Qualified higher education expenses are defined as "tuition and fees required for enrollment or attendance of the taxpayer (purchaser of the bonds), the taxpayer's spouse, or any dependent of the taxpayer." This limitation actually has two drawbacks. While tuition and other fees are considered to be qualified, the payment of room and board is noticeably omitted. Also, if the purchaser of the bonds happens to be a grandparent of the child, then the tax-free portion of the provision does not apply.

While the above reasons are enough to bring into question the wisdom of Section 135, the real problem is the income limitation of the provision. Under Section 135, the tax-free gain on redemption will only apply, if at the time of redemption, the taxpayer meets certain adjusted gross income requirements. The interest income exclusion will be phased out for taxpayers with adjusted gross income above certain levels. For those taxpayers filing joint returns, the phase-out range is from $60,000 to $90,000, while those filing single, or head of household, have a phaseout range of $40,000 to $55,000. If the adjusted gross income exceeds the $60,000 ($40,000 if single or head of household) the amount of the interest that would be excludable will be reduced by an amount that bears the same ratio
to the amount otherwise excludable as the excess adjusted gross income bears to $30,000 ($15,000 if single or head of household).

Example

Mr. and Mrs. Smith, who file a joint return, redeem a $10,000 qualified United States Savings Bond to apply to qualified higher education expenses for their son, Robert. The $10,000 the Smiths receive represents $5000 of principal and $5000 of interest income. Since the qualified higher education expenses for the year were $10,000, the entire $5000 of interest income appears to be excluded from the Smiths' gross income. However, if their AGI exceeds $60,000 there must be a phaseout reduction. If their AGI is $80,000, then the phaseout reduction if $3333, and the excludible amount is $1667, instead of $5000. The Smiths arrived at the phaseout reduction by taking the otherwise excludible amount ($5000) and reducing it by an amount that bears the same ratio to it ($5000) as the $20,000 excess AGI ($80,000 modified AGI minus $60,000 modified AGI limit) bears to $30,000. If the Smiths AGI were $60,000, they would have a zero excess AGI and be entitled to the full $5000
exclusion. If their AGI is $90,000 or more, then the phaseout reduction would be $5000 and their exclusion amount would be zero.

As one can see, the Section 135 benefit is lost as ones income increases. It appears that the federal government is saying that only certain income level individuals are entitled to federal assistance, by way of favorable tax treatment, in planning for future college costs. In addition, the decision to purchase U.S. Savings Bonds today, while ones income is low or moderate, to fund college costs for ones child fifteen years later, requires a projection of the taxpayer's adjusted gross income way off in the future. In many of our cases this is quite difficult, if not impossible. The limitation and the need for future information makes Section 135 of limited value to many of the people who are searching for assistance.

B. SENATE BILL 612

During the summer of 1991, Senator Lloyd Bentsen and Senator William V. Roth introduced Senate Bill 612, commonly referred to as the Bentsen-Roth IRA. While this bill is designed to assist taxpayers in a number of other areas, the financing of future college costs is one of its prime goals. The bill would allow individuals to create special IRA accounts designed for education. Each year, an individual would be allowed to contribute up to $2,000 in this special IRA. While no deduction would be allowed for the contribution, the money would grow tax-
free (similar to the savings bonds, but hopefully at a higher rate of return) and the withdrawal from the IRA would be tax-free if used to pay qualified higher education expenses.

While this sounds a lot like the savings bond program, there are two major improvements. One, the granting of tax-free status on earnings is not restricted or phased-out based on the taxpayer's income at withdrawal. This makes this program available to many more people. Second, unlike the savings bonds program, this bill would also allow grandparents to directly assist in providing tax-free financial help. In addition, this special IRA has a outstanding flexible feature. If the funds are not needed for the education of my child, I can wait and use the funds (tax-free), for the education of my grandchildren, the graduate education of my children, the purchase of a first home for my children or my own medical expenses as I grow older.

While certainly an improvement over what the government has done so far, the bill could actually be stronger. One, the contribution could be deductible, thereby allowing before tax dollars to be used to fund this special IRA. Second, the definition of qualified higher education expenses should be extended to include room and board costs.

During the past couple of years, several other bills with similar provisions have been proposed. I believe this bill has the best chance of becoming law since both of the sponsors are members of the powerful Senate Finance Committee.
C. SENATE BILL 2159

On January 24 of this year Senator Boren, also a member of the Senate Finance Committee, reintroduced Senate Bill 2159, commonly called the "Tax Fairness an Competitiveness Act of 1992." While the bill touches on a number of topics, Subtitle A of the bill is entitled "EDUCATIONAL INCENTIVES" and provides a number of measures that could help with the funding of college costs. In essence, this provision has three major assisting components. First, the bill would restore a tax deduction for interest paid on educational loans or expenses. Under this provision, the taxpayer actually would have the option of taking the deduction or a credit (15% of the interest paid under to $300) against tax owed for the interest paid on educational loans. The credit election is very important for those taxpayers who are unable to itemize deductions and might appear to be losing the opportunity to deduct the interest paid. Second, the bill expands the definition of qualified higher education expenses to include reasonable living expenses while away from home. This appears to be the first recognition that part of ones financing for future college includes expenses for living and eating. It appears that is a must in any plan. This new definition would actually become part of Section 117, thereby changing all definitions of qualified higher education expenses that refer to Section 117 for guidance (i.e., Section 135). Certainly this is a great improvement over existing law. Finally, Senate Bill 2159 would expand Section 135's exemption
from gross income to include not only income from savings bonds, but also income from any qualified college savings account. For the purpose of this provision, a qualified college savings account would include any prepaid tuition contract (state program) and any trust created or organized for the exclusive benefit of an eligible holder or his beneficiaries (educational trust).

Once again, on its face, this bill appears to be right on target. In fact, the restoration of the interest deduction, the option of a credit and the expanding definition of qualified educational expenses are all excellent provisions, however the bill does have three major flaws. First, the bill is extremely complex and full of exceptions and limitations. Your tax savings might end up going to pay a tax attorney to help you understand the bill and keep you on the straight and narrow. Second, the portion of the bill that relates to the new college savings account has a similar income restriction as the one that appear in the savings bonds program under Section 135. Once again, limiting access to only a portion of the population. Finally, with the exception of the U. S. Savings Bond program, the college savings account provision does not provide for tax-free accumulation of earnings during the life of the investment. In essence, unless some other provision helps, the earnings in the prepaid tuition contract and the educational trust will be taxed yearly. Certainly, this part is not as good as the savings bond program or the special IRA proposal.
D. THE NEW TAX BILL.

In the 1992 State of the Union message, President Bush instructed Congress to enact, by March 20, 1992, a number of proposed tax measures. While Congress did not feel that they could be "instructed" to do so, they in fact went to work on such matters. A number of the President's proposals, as well as the House and Senate versions, do have implications in the educational finance arena.

Both the President and the House propose allowing penalty-free (not tax-free) withdrawal of funds from an individual's IRA to pay qualified educational expenses. For this purpose, reasonable living expenses while away at school would not be included in this amount. The Senate would include withdrawals from 401(k) and 403(b) plans in this penalty-free grouping. While penalty-free withdrawal is good, tax-free would be a great addition to this.

While the President and the House had no provision for the expansion of the Section 135 savings bonds program, the Senate suggested two major improvements. One, qualified expenses would include those paid for any individual, not just dependents. This would allow grandparents, older brothers and sisters, aunts and uncles to all purchase savings bonds to help with the child's educational costs. Second, the adjusted gross income phase-out would be repealed. This would allow everyone to gain benefits from the program. This would be a major improvement.
In the area of student loan interest, the three parties all had different proposals. The President suggested that interest on post-secondary education loans be allowed as an itemized deduction. The House proposed a non-refundable tax credit for 15% of educational loan interest with a maximum credit of $300 (in certain cases this could be increased to $500). This credit would phase-out if the individual's adjusted gross income reached $100,000 on a joint return. The Senate version adopted Senator Boren's proposal of Senate Bill 2159 which provided the individual an option of the President's deduction of the House's credit. In addition, the Senate suggested the creation of a "Self-Reliance Loan" for eligible students to cover higher education expenses. These would be loans from the federal government for up to $5,000 a year ($15,000 if graduate students) with a lifetime cap of $30,000. The key to this provision is that repayment of the loans would be made through addition to annual income tax liability using a formula that multiplies the repayment rate (3%, 5%, or 7% depending on total indebtedness) by adjusted gross income. While this self-reliance loan sounds really great, as a tax lawyer I would warn people about having an additional tax liability, as opposed to a loan debt. Proceed with due caution.

STATE GOVERNMENT

The major action in post-secondary savings programs has occurred at the state level. Basically, there exists three major
types of programs, each with separate tax consequences and problems.

A. COLLEGE SAVINGS BONDS

The various college savings bonds program, such as the ones offered in Illinois and Ohio are very straight forward and uncomplicated. Basically these are nothing more than zero-coupon type investment bonds that carry a set redemption amount at maturity (i.e. $5,000). However, the purchase price of the bonds will vary with the length of maturity (i.e. $900 to $3,500). At maturity, the bond is redeemed at its stated amount and the difference between the cost and the redemption amounts (the earnings) is received tax-free. This is nothing more than a municipal bond that has been issued by the state and labeled a college savings bond. In most cases, the proceeds do not even have to be used for educational expenses in order to gain the tax exemption.

While this is certainly an easy, simple program, it has two major drawbacks. First, the interest rate earned on municipal bond type investments takes into consideration the tax exemption concept and therefore tends to be much lower than regular market rates of return. Therefore, it either takes longer to earn the amount of money needed or an individual would be required to invest a greater amount up front. The second drawback is the lack of guarantee that what you do earn will cover the rising costs of a college education. This need to properly address the
rising costs and how to project the right amount is taken care of by the states in the other two types of programs.

B. THE PRE-PAID CREDIT PROGRAM

Under this type of program, an individual can purchase college credits today, at a set price, to be used in the future. Under the Ohio plan, each tuition credit is worth 1% of the weighted average of the annual cost of tuition at the state's public universities and colleges at the time of redemption. The plan allows parents or other benefactors to purchase up to 400 tuition credits, per beneficiary, for use in the future. This actually allows a family to at least lock in the cost of tuition for a child's future college education. For example, parents could purchase, on behalf of their child, 400 college credits today at $35 per credit. Total cost would be $14,000. If fifteen years from the purchase date, when the tuition at Ohio State University is $42,000, the child's tuition cost would be covered. All the child would have to do is redeem one-fourth of the purchased credits each year to pay her tuition. While this appears all clean and uncomplicated, there are at least three hidden tax concerns in this program.

First, upon the purchase of the credits by the parent, or other, for the child, there is the real possibility of some type of gift being made. If this is the case, the question of gift tax becomes important. Since it appears to be a gift of a future interest, the annual $10,000 exclusion would not be available.
However, there maybe three additional avenues of help in this regard. One, if a parent purchases the credits, might not the parent claim this is not a gift but the fulfillment of a legal responsibility for providing education to their children? Other purchasers of the credits would not be able to use this argument. Next, the purchaser could argue that the payment of the credits, while a prepayment, actually fits within the gift exception under Section 2503(e)(2)(A) of the Code. This section provides an exception from the classification of a gift, and therefore from the gift tax, for any amount paid on behalf of an individual as tuition to an educational organization. While the tuition payments are not going directly to an educational organization, the taxpayer might be successful in claiming a substance over form argument so often used by the Internal Revenue Service. Finally, the taxpayer might argue that the payment price for the credits by a purchaser are in the nature of a deposit for the benefit of the beneficiary. If the beneficiary fails to attend college, the payment, with some gain, will be refunded.

The second hidden tax, occurs when the individual redeems the tuition credit. If the cost of the credit was $35 and on the date of redemption, one credit hour of tuition now costs $105, then the individual has received a benefit worth $70. Simple tax demands that the $70 is income and must be included in the redeeming individual's gross income in the year of redemption. In essence, the difference between the cost of the credit and the value at redemption is taxable to the redeemer. This is the
amount that Senator Boren's bill would exclude from gross income under certain conditions. However, presently this amount is clearly taxable and the states that sponsor this type of plan have accepted that conclusion.

The third concern involves the tax consequences of the investment earnings of the authority sponsoring the program, in most cases the state or some part of the state. The major question is "do the earnings of the sponsoring authority rise to the level of taxable income to the authority or are they somehow exempt? If taxable, this will decrease the return capabilities of the authority, therefore increasing the purchase price of the credits. On the other hand, if the earnings are allowed to grow tax-free, the return of the authority would be increased and the purchase price of the credits could be lower. Authority takes the position that these earnings are exempt from taxation, pursuant to Section 115 of the Code. Section 115, one of the shortest sections of the Code, simply states that "gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof,....". The sponsoring authorities believe that the income earned on the investments of the authority should be exempt from tax under Section 115 since such income is derived by the authorities in the performance of an essential governmental function which accrues to the benefit of the state. In addition, the authorities have also made the argument that the income earned on the investments should be
exempt from federal income taxation pursuant to the Doctrine of Intergovernmental Tax Immunity since the authorities are a state instrumentality. On March 30, 1990, the Ohio Tuition Trust Authority requested the Internal Revenue Ruling to rule on these points, but as of this time, the Service has yet to officially reply. In addition to the request for a ruling, the Ohio Tuition Trust Authority is attempting to get Congress to amend Section 115 to include in its exemption, the income earned by state-created tuition trusts such as the ones discussed here.

C. TUITION PREPAYMENT PLANS

The third type of state program, and the one where much of the tax action has occurred, is the prepaid tuition programs, such as Michigan's Michigan Education Trust (MET) and Florida's Florida Prepaid Postsecondary Education Expense Program (FPPEEP). Under these types of programs, the purchaser makes a single payment (actually it can be made by installment payments) and four years of college tuition at one of the State's colleges or universities is guaranteed. For example, in 1990, a parent could purchase four years of guaranteed tuition, for their newborn child, at any Michigan state college for $8,380.

Before selling their first MET contract, the Michigan Authority was required to obtain a ruling from the IRS stating that, during the administration of the program, the income earned by the Authority would not be taxed to the purchaser, or the beneficiary. While the requested ruling did in fact exempt the
purchaser or beneficiary from taxable income during the period of administration, other taxable events were exposed.

All three of the taxable events are very similar to the points raised above in the pre-paid credit discussion. However some of the outcomes may appear different. On the issue of taxable income to beneficiary when he receives the educational services, there is little argument. The Service states and it appears that the excess of the fair market value of the educational services, when received under the contract, over the payment for the contract is includable in the gross income of the beneficiary, or refund designee. The second issue involves the question of a gift by the purchaser of the contract to the beneficiary. The ruling clearly states that a gift has been made, and that the two possible exceptions were not available in this case. Since the payment was not directly made to an educational institution, the section 2503(e)(2)(A) exclusion would fail. In addition, since this was in fact a gift of a future interest, the Section 2503(b) $10,000 per year exclusion would also fail. While there is little chance any purchaser of one of these contracts will have to actually pay any gift tax (unified gift tax credit should cover it) each purchaser of a contract would be required to file a gift tax return in the year the contract is purchased or payments are made on behalf of the contract. In fact, the Michigan Authority has been forthright about this fact and has informed its purchaser of this
requirement and in some cases forwarded the necessary forms needed to be filed.

The third tax issue, the one where all the action has been centered around, involves the question of the income of the Authority's trust. In the ruling request by the Michigan Authority, the Authority stated that it was their belief that since the income earned by the Trust during, the administration of the program, was income earned by an integral part of the state it was therefore excludable. In the alternative, the income was derived from the exercise of an essential government function that accrues to the State, and should be excluded from gross income under Section 115 of the Code. In response, the Service recognized that income earned by an integral part of a state or a political subdivision of a state is generally not taxable, however, the Service also found that the facts associated with the Michigan MET indicated that the Trust was not an integral part of the State of Michigan or one of its political subdivisions. In addition, the Service ruled that even if the income of the Trust serves a public interest, in order for the income to be exempt under Section 115, it could only serve a private interest incidental to the public interest served. The Service found that in the case of the Michigan Trust the private interest served (educational payments to beneficiaries of purchased contracts) was more than incidental to the public interest (an educated society) and therefore failed the Section 115 test. Therefore, the income earned by the Trust, during the
administration of the program, was in fact includable in the Trust's gross income and subject to federal income tax.

Clearly unhappy with the outcome of the results concerning the Trust income question, the State of Michigan and its Michigan Education Trust has filed suit against the United States government. The Trust filed its tax return (actually filed as a corporation), paid the tax on the earnings and filed for a refund. When the refund was denied, the Trust and the state of Michigan filed suit in United States District Court, Western District of Michigan. The sole issue revolves around the taxability of the income of the Trust during administration of the program. In the State of Michigan's Brief in Support of Motion For Summary Judgment, the State and its Michigan Education Trust makes six arguments as to why the Michigan Education Trust should be exempt from tax. The six theories are as follows:

A. The Michigan Education Trust is not an entity which is taxable under the provisions of the Code, because it is an agency of the sovereign State of Michigan.

B. The United States is prohibited by the modern constitutional Doctrine of Intergovernmental Tax Immunity from imposing an income tax on the State of Michigan and its Michigan Education Trust.

C. The United States is prohibited from imposing an income tax on the State of Michigan and
its Michigan Education Trust, because imposition is discriminatory in its application, also in violation of the constitutional Doctrine of Intergovernmental Tax Immunity.

D. The United States is prohibited from imposing an income tax on the State of Michigan and its Michigan Education Trust by the Guarantee Clause of the United States Constitution.

E. If the Code were held to be applicable to the Michigan Education Trust, then the Michigan Education Trust's income is properly excludable from gross income under Section 115 of the Code.

F. If the Code were held to be applicable to the Michigan Education Trust and the Michigan Education Trust's income is not excludable under Section 115 of the Code, then the Michigan Education Trust is an organization entitled to recognition as a tax exempt entity under either Section 501(c)(3) or Section 501(3)(4) of the Code.

Clearly alternative pleading at its best.

As expected the United States government in its Brief For The Defendant In Support Of Its Motion For Summary Judgment stated that the State of Michigan and its Michigan Education
Trust were clearly wrong on each and every point. The federal
government contends that the Michigan Education Trust's income is
not excludable by Section 115, nor does federal taxation of the
Trust's income violate any constitutional protections or run
afoul of intergovernment tax immunity or the nondiscrimination
doctrine. In addition, as stated to the Michigan Education Trust
in its request for tax exempt status under Section 501(3) or (4),
it did not qualify as a tax-exempt charitable organization.

At the present, there has been no decision in this case,
therefore the ultimate answer to this important question is
unclear. It is my belief that no matter how the United States
District Court rules, this will not be the end to this question.
I expect to see the loser appeal the decision to the Sixth
Circuit Court of Appeals. It should be noted that Florida's
program has requested a Internal Revenue Ruling also, concerning
the same point. However, Florida takes the position that the
earnings on funds invested in its prepaid program are exempt from
federal taxation since their contracts are backed by the "full
faith and credit" of the state. This is not the case in the
Michigan program. Florida sees this as the key difference
between its program and the Michigan Education Trust. Florida
feels this distinction makes its program, in operation, an
integral part of state government, therefore allowing its income
to be excludable from gross income.

THE PRIVATE SECTOR

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Of course, one can attempt to provide for the future cost of higher education without the benefit of any assistance by the federal or state governments. In fact, there is plenty of help available in other areas. Insurance companies are willing to show you how annuity contracts and cash value life insurance is the key way to provide money for future educational costs. While they are correct that the income builds up tax-free, one must be concerned about the rate of return and the tax consequences on distribution. Also in this day, the security of the insurance company itself must be considered. Brokerage houses are ready to assist you also. After all we all know that over time nothing out paces the stock market. We also know that the stock market is risky, dividends are taxable and certain gain on the sale of any stock will clearly produce taxable income. Of course, a broker can put you into tax free municipal bonds that mature over a four year period. The same four year period that your child will be attending college. Certainly, the income earned is tax free under Section 103 of the Code. But most states can give you the same deal with their educational savings bonds and without a brokerage commission.

There are private companies and banks who will sell you different types of plans that will help you meet the ever increasing costs. One such company is College Savings Bank of Princeton, New Jersey, which offers a CollegeSure CD whose interest rate changes each year to match the escalating college cost. While these plans tend to give you a little more
flexibility as to the choice of colleges, be very careful and look closely at the tax aspects of each. Employers have even entered the arena, RJR Nabisco has created a program of loans, scholarship and up to $4,000 of matching funds, in an effort to assist its employees. They have stated that a child of a RJR Nabisco employee will not be denied a college education because of money.

Many magazines such as Money, Newsweek, Black Enterprise, and others will carry articles on how to save for college. Most have excellent ideas such as passbook accounts, mutual funds, CD's, bonds, custodial account and rental real estate, however, remember all of these have tax aspects that must be considered.

CONCLUSION

No question, providing for future higher education costs for our children has reached a new level. I personally have U.S. savings Bonds, have purchased tuition credits, have municipal bonds, own mutual funds, have a Section 403(b) account, own rental real estate, hope to use discount tuition provisions from my employment at The Ohio State University and am still searching for the best plan for my two-year old daughter. But before any of this, I consulted with not one, but two attorneys. One, a tax attorney, myself. The other the real boss, my daughter's mother. In this endeavor, two heads are better than none, one or whatever.