PAYING FOR A (GRAND) CHILD'S

EDUCATION

MAKING EDUCATED CHOICES*

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When the older generation of a family wants to make a positive difference in the lives of the younger generations, providing funds for their education is often seen as a way of leaving them with a lasting legacy. However, the cost of education is rising precipitously. While daunting college tuition bills have always been a concern to many parents and grandparents, the coronavirus pandemic and the resulting economic crisis have only served to exacerbate those concerns. Now more than ever, it is important to evaluate college funding alternatives.

FINANCIAL AID CONSIDERATIONS

An important consideration is the effect of funding techniques on a student's ability to qualify for financial aid. For federal financial aid eligibility, institutions rely on information submitted on the Free Application for Federal Student Aid (FAFSA). FAFSA now collects information from two tax years before the beginning of the school year. Students and their parents are required to make certain percentages of their assets available for tuition. For students, 20 percent of their assets are considered available for college tuition.[1] Expected parental contributions are calculated according to a bracketed scale, with a maximum of 5.64 percent of parents' assets considered available for tuition. Assets of other family members are not considered.

SELECTED EDUCATION FUNDING TECHNIQUES: TAX-FREE OPTIONS

Direct Payment of Tuition Expenses

Internal Revenue Code (I.R.C.) Section 2503(e)(1) provides that a "qualified transfer" is not treated as a gift for gift tax purposes. Section 2503(e)(2)(A) defines "qualified transfer" as "any amount paid on behalf of an individual as tuition to an educational organization…for the education or training of such individual." Therefore, a donor may make unlimited payments directly to an educational institution, and those payments will not be considered gifts. There are no restrictions regarding education level. Payments must be made directly to the educational institution and must be for tuition only.

One of the advantages of making direct payments is simplicity. Another advantage is that tuition payments are not treated as gifts and therefore do not impact the donor's ability to make other gifts to the same students. Further, direct payment of education expenses on behalf of grandchildren is not subject to generation-skipping transfer (GST) tax, the tax imposed at the highest estate and gift tax rate on transfers that skip a generation.[2]

There are no income tax consequences associated with direct payment of tuition expenses. For financial aid purposes, direct payment of tuition expenses will likely be considered a resource that will reduce the student's financial aid awards on a dollar-for-dollar basis.

Since expenses such as room and board, books, and fees do not qualify for the exclusion from gift tax, establishing a 529 plan, in addition to directly paying tuition, will allow for the payment of incidental expenses in a tax-advantaged way.

Prepayment of Tuition Expenses

In an Internal Revenue Service (IRS) Private Letter Ruling (PLR) issued on September 6, 2005,[3] the IRS authorized grandparents to prepay tuition expenses to an educational institution for six grandchildren up to grade twelve. Prepayment of tuition expenses removes the risk that the grandparents might die before all tuition payments are made. Prepayment is also very effective in transferring large sums tax-free from the grandparents' estates.

One disadvantage is that the prepayments described in the PLR were nonrefundable. Therefore, payments might be forfeited if a grandchild did not attend the school, and increases in tuition levels over the years would require the transfer of additional funds.

There are no income tax consequences associated with the prepayment technique. In terms of impact on financial aid, if the tuition is not prepaid in its entirety, the prepaid amount would likely be considered a resource and would reduce financial aid awards on a dollar-for-dollar basis.

Because payment to an educational institution is not considered a gift under Section 2503(e), prepayments do not impact the grandparent's ability to make other gifts to the same students. Prepayment of tuition can also help equalize payments among older and younger grandchildren. If the prepayment is made as a deathbed transfer, it will not be brought back into the estate as an adjusted taxable gift.

Annual Exclusion Gifts

Annual exclusion gifts can be made in each calendar year to any number of recipients, up to $15,000 for 2020.[4] Annual exclusion gifts (either outright transfers or transfers to certain types of trusts) are free from both gift and GST taxes.

Instead of outright gifting, the following estate planning techniques that can leverage annual exclusion gifting are worthy of consideration:

State-level statutory accounts. A custodial account under a Uniform Gift to Minors Act (UGMA) or a Uniform Transfer to Minors Act (UTMA) can be established by a donor for young children. The accounts are governed by state statute rather than a trust document. The funds belong to the minor, but

1 20 U.S.C. § 1087oo(a)(3).
2 I.R.C. § 2602. The GST tax exemption for 2020 matches the $11.58 million gift and estate tax exemption amounts.
3 I.R.S. Priv. Ltr. Rul. 200602002 (Sept. 6, 2005).
4 I.R.C. § 2503(b).

the donor appoints a custodian to control the account until the child reaches the age of termination (typically eighteen or twenty-one, depending upon state law).[5]

UGMA and UTMA accounts are easy and inexpensive to establish. While outright annual exclusion gifts are exempt from GST taxes, other transfers will also be exempt only if both of the following requirements are met:

- No income or principal is payable to anyone other than a specified beneficiary.
- The funds will be includible in that beneficiary's estate, in the event the beneficiary dies before age twenty-one.

Transfers (within annual exclusion limitations) to the custodial accounts are exempt from GST taxes: the nature of a custodial account is such that the child is the only allowable recipient of income or principal, and if the child dies before age twenty-one, the funds will be included in the child's estate.

One disadvantage of setting up a custodial account is that when the child reaches the age at which the custodial account terminates, the funds belong to the child absolutely. They are not earmarked for education purposes.

In terms of the income tax consequences, the income in a custodial account is taxed to the child and is subject to the so-called kiddie tax. Pursuant to the kiddie tax, the unearned income of a child exceeding $2,200 (for 2020) will be taxed at the rates paid by the child's parents. The kiddie tax applies to eighteen-year-olds (until the year the child reaches nineteen) and to students under age twenty-four who do not earn more than half of their support. For financial aid purposes, a custodial account is treated as an asset of the child.

When appointing a custodian of the account, consider the possibility that if a parent acting as custodian dies, the custodial funds could be taxable in the parent's estate due to the support obligation owed by parent to child. Accordingly, it may be wise to appoint a custodian other than a parent.

Crummey trust. A Crummey trust can be established for a child or grandchild, and transfers to the trust qualify for the annual gift tax exclusion through the mechanism of a withdrawal power. Each time property is gifted to a Crummey trust, the beneficiary has a brief window of time (generally thirty to sixty days) to withdraw the contribution. If the beneficiary does not withdraw the contribution, the property remains in the trust until the trust terminates.

Although gifts in trust are generally considered future interests (because the recipient's enjoyment of the property is deferred to a future time), a current withdrawal right granted to a beneficiary can convert the future interest into a present interest. To do so, each time a contribution is made, a notice must be sent to the beneficiary informing the beneficiary of the beneficiary's right to withdraw the property. Although there can be no formal agreement, there is generally an understanding that the child will not withdraw the annual trust contribution.

Under the provisions of a single Crummey trust agreement, it is possible to create separate trusts for multiple beneficiaries. The trust can remain in effect as long as the trust instrument specifies. Trust funds are not earmarked for education purposes: if tuition is paid directly, trust funds can be used for other purposes.

One downside is the administrative inconvenience associated with annual Crummey notices. It is also necessary to allocate GST exemption if a single Crummey trust has more than one beneficiary in order to shield the trust from GST tax exposure.

From an income tax standpoint, the Crummey trust can be structured as a grantor trust, resulting in the trust's income being taxable to the grantor during the grantor's lifetime. The payment of income taxes by the grantor is, in effect, an additional tax-free gift to the beneficiaries because the trust, as a practical matter, can grow tax-free. After the grantor's death, the trust will be treated as a separate taxpayer for income tax purposes, and any undistributed income will be taxable to the trust. However, with careful structuring, it may be possible to avoid state taxation at the trust level by creating the trust in a jurisdiction like Delaware. Alternatively, the trust can be structured as a separate taxpayer. If so, undistributed income will be taxable to the trust. Crummey trust beneficiaries will be treated under I.R.C. Section 678 as owners of the portion of the trust over which the withdrawal power can be exercised. Income distributed to a child may be subject to the kiddie tax.[6] For financial aid purposes, a Crummey trust for a single beneficiary is treated as an asset of the student.

Structuring a Crummey trust so that there is only one beneficiary per trust allows the annual exclusion gifts to be transferred to the trust GST tax-free. If a single Crummey trust has more than one beneficiary, the trust will have GST tax exposure unless the donor allocates GST exemption to the trust.

Section 2503(c) trust. A trust established under I.R.C. Section 2503(c) is designed to hold gifts in trust for a child until the

5 States with eighteen as the age of termination include California, Kentucky, and Louisiana. States with twenty-one as the age of termination include Illinois, North Carolina, and Virginia.

6 Rev. Proc. 2019-44, 2019-47 I.R.B. 1093 (2019).

child reaches age twenty-one. Section 2503(c) creates an exception to the present interest requirement for annual exclusion gifts, allowing a gift in trust for a minor to qualify for the gift tax annual exclusion. In order to satisfy Section 2503(c), all of the following conditions must be met:

- The trust property and income earned on the trust property may be paid to or used exclusively for the benefit of the minor before age twenty-one.
- All undistributed property and income must be paid to the minor when the minor reaches age twenty-one.
- If the minor dies before age twenty-one, trust property must be included in the minor's estate.

The Section 2503(c) trust can be extended by giving the minor a limited opportunity (often thirty, sixty, or ninety days) to withdraw the funds at age twenty-one. This limited opportunity to withdraw satisfies the requirement that the minor receive the trust property at age twenty-one. If the child does not exercise the right to withdraw the property, the property can remain in trust until the child reaches a certain age, or for the child's lifetime. Annual $15,000 contributions to a Section 2503(c) trust will not be subject to GST taxes: by its nature, a Section 2503(c) trust is structured to benefit a single beneficiary, and the property must be included in the beneficiary's estate if death occurs before age twenty-one.

An advantage of the Section 2503(c) trust is that it is less administratively burdensome. There is no requirement for notices to be sent when transfers are made to the trust. Multiple family members can make gifts to a trust established by a single donor for the benefit of a particular beneficiary. The trust funds are not earmarked for education purposes: if tuition is paid directly, trust funds can be used for other purposes. A downside is that once the child turns twenty-one, transfers to the Section 2503(c) trust will no longer qualify for the gift tax annual exclusion. Additionally, the child will have an absolute right to withdraw the funds at age twenty-one, even if only for a limited time period.

The Section 2503(c) trust can be structured as a grantor trust or a separate taxpayer. The trust is treated as an asset of the child for financial aid purposes.

Section 2503(c) trusts can be converted to Crummey trusts after the beneficiary turns twenty-one, so transfers to the trust continue to qualify for the gift tax annual exclusion. Once the trust becomes a Crummey trust, Crummey notices must be sent out at least annually.

529 plans. A 529 plan is an investment account created by a donor in the name of a designated beneficiary for the purpose of paying education expenses. Funds invested in a 529 plan will accumulate and grow free of federal income tax, and if the funds are used for qualified education expenses (for college: tuition, room and board, fees, books, supplies, and equipment; for elementary, middle and high schools: tuition only), they are exempt from federal income tax.

529 plans are vehicles created under federal law, but every jurisdiction has a plan. Although a donor is not required to participate in the donor's state plan, there may be state income tax incentives to do so. There are three main factors to consider when determining which state plan to use:

- state tax benefits
- investment options
- cost

Previously, 529 plans could be used to pay only qualified higher education expenses. However, as a result of changes effected by the Tax Cuts and Jobs Act of 2017,[7] as of January 1, 2018, 529 plans can also be used to pay for elementary and secondary schools up to $10,000 for federal tax purposes. Note that not all states characterize 529 plan distributions for K-12 tuition as qualified distributions for state tax purposes.

The most prized benefits of a 529 plan include the tax-free accumulation and distribution of funds for federal purposes, unlimited distributions for college-level expenses, and now the ability to make distributions up to $10,000 annually for any education level. In addition, many states accord similar favorable tax treatment to 529 plans, allowing funds in the plan to grow tax-free, and exempting distributions from state income tax if made for qualified education expenses. Many states also allow an income tax deduction for contributions to a resident's state-sponsored 529 plan.

One thing to be cautious of is a potential state income tax deduction clawback: In many states, the income tax deduction is subject to recapture for nonqualified withdrawals, including a rollover to a 529 plan outside the state. If some states do not characterize 529 plan distributions for K-12 tuition as qualified distributions, they might be subject to recapture, which would eliminate any prior state tax benefit.

An interesting feature of 529 plans is the option to frontload contributions to the plan by making up to five years' worth of annual exclusion gifts ($75,000 per person or $150,000 per married couple) in a single year to any number of beneficiaries.[8]

7 Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf,
8 I.R.C. § 529(c)(2)(B).

Additionally, a donor may change the beneficiary of the plan at any time without penalty. If the donor needs funds, the donor can withdraw 529 plan funds at any time (subject to income taxes and a withdrawal penalty). The ability to make an irrevocable gift and also retain the power to withdraw the plan funds makes this a unique estate planning tool.

Contributions to a 529 plan must be in cash. Securities and other property are not permitted. Note that gifts to a 529 plan reduce the amount otherwise permissible for annual exclusion gifting. In addition, investment choices are limited to the ones provided by the state plan. The 529 plan investment strategy can be changed twice per calendar year. There may be gift tax liability associated with changing the beneficiary of a 529 plan to a new beneficiary who is in a younger generation. There may also be GST tax liability associated with changing the beneficiary of a 529 plan if the new beneficiary is two or more generations below the original beneficiary.

For purposes of financial aid for dependent students, 529 plans are treated as an asset of the parent, regardless of whether the parent or student is the account owner. All 529 plans owned by a student or the student's parents are reported on the FAFSA. If a 529 plan is owned by a grandparent or a family member other than a parent, it will be disregarded as an asset in a federal financial aid analysis (although some state financial aid applications require the reporting of all 529 plans for the benefit of the student, regardless of the account owner). However, distributions from a 529 plan may be treated as a beneficiary's untaxed income, potentially reducing financial aid eligibility by up to 50 percent of the distribution amount. To prevent adversely affecting the student's financial aid eligibility, a distribution from a grandparent-owned 529 plan might be delayed until January of the student's sophomore or junior year, since it will not impact another FAFSA if the student graduates in four years.

529 plans are a particularly effective tool for grandparents who wish to equalize payments among older and younger grandchildren. Funding a 529 plan, and taking advantage of the frontloading option, eliminates the risk that the grandparent might not set aside tuition payments before the grandparent's death.

TAXABLE GIFTS

Dynasty Trust

A dynasty trust is a trust designed to hold assets for the benefit of successive generations. In addition to the $15,000 annual gift tax exclusion, in 2020, each person has up to $11.58 million that can be used to fund a dynasty trust. On January 1, 2026, this historically high exemption is scheduled to sunset to $5 million, indexed for inflation, and many believe that federal exemption amounts will be reduced much sooner, as that is part of the Biden administration plan. This creates added incentive to take advantage of current high exemption amounts, particularly because the IRS has confirmed that there is no clawback or recapture risk if the exemption is lower at the date of an individual's death.[9] In addition to sheltering the trust from gift taxes, the donor can shelter the trust from GST tax liability by allocating the GST exemption, which mirrors the federal estate and gift tax exemption amount.

One of the advantages of setting up a dynasty trust is that a transfer of funds to the trust reduces the donor's estate not only by the amount of the funds transferred, but also by the future appreciation on those funds. Drafting the trust with flexibility can allow it to benefit children and grandchildren over multiple generations. Establishing the trust in a jurisdiction that has abolished the rule against perpetuities allows the trust to continue indefinitely. Under Delaware law, for example, there is no limit to a trust's duration. Therefore, assets can generally continue in trust free of estate, gift, or GST taxes.[10] Since multiple beneficiaries across generations are typically permissible beneficiaries, there is no concern about equalizing younger family members for prior gifts to older family members. The trust funds need not be earmarked for education purposes. Particularly since trust funds might exceed education expenses in light of elevated exclusion amounts, they are also available for other purposes.

A consideration in utilizing a dynasty trust is a potential loss at death of step-up in basis of assets transferred, since those assets will not be included in the estate (unless there is a mechanism established to bring the assets back into the donor's estate if a step-up is desirable).

A dynasty trust can be structured as a grantor trust for income tax purposes. After the grantor's death, the trust will be treated as a separate taxpayer. However, state taxes at the trust level can potentially be avoided by careful planning, utilizing a jurisdiction like Delaware. Distributions from the trust to a beneficiary will be taxed at the beneficiary's rates and will be subject to the kiddie tax, if applicable.

A dynasty trust is typically established for the benefit of multiple beneficiaries, with a trustee that determines, in its sole discretion, which beneficiaries will receive distributions and in

9 T.D. 9884, 84 Fed. Reg. 64995 (Nov. 26, 2019), https://www.govinfo.gov/content/pkg/FR-2019-11-26/pdf/2019-25601.pdf.
10 Del. Code Ann. tit. 25, § 503 (2020).

what amounts. Therefore, a dynasty trust's effect on financial aid eligibility is unclear.

The donor can continue to make $15,000 annual exclusion gifts to the dynasty trust, provided Crummey withdrawal powers are incorporated in the trust document.

Health and Education Exclusion Trust

I.R.C. Section 2611(b) excludes from the definition of "generation-skipping transfer" any transfer that "if made inter-vivos by an individual would not be treated as a taxable gift by reason of Section 2503(e)." Therefore, a distribution from a non-GST exempt trust that is established for direct payment of education or medical expenses of a grandchild or a more remote descendant (a health and education exclusion trust (HEET)) would not be considered a generation-skipping transfer (because if that payment were made inter vivos, it would not be a taxable gift). Therefore, a grandparent can create a non-GST exempt trust to pay for the tuition and medical expenses of grandchildren or more distant descendants. If created in a jurisdiction like Delaware, the trust can last in perpetuity.

The problem is that GST tax is imposed when there is a transfer to a skip person (a person two or more generations below the donor). GST tax is triggered when only skip person beneficiaries hold interests in a trust. This will occur when the last beneficiary who is not a skip person dies. At that point, the trust itself will be a skip person and a taxable termination will occur.

A potential solution is to include a charity as a HEET beneficiary, which will prevent a taxable termination from occurring because the charity is not a skip person. Since the charitable interest will last in perpetuity, the trust itself will never become a skip person, and there will never be a taxable termination. Distributions to charity must be significant in order to prevent the IRS from disregarding the charitable interest. Practitioners often recommend an annual distribution to charity of at least 10 percent to qualify as a significant interest. Overall, HEETs generally work best for very wealthy individuals who have fully utilized their GST tax exemption with other planning vehicles or expect to.

The main advantage of setting up a HEET is that the trust need not have a GST exemption allocated to it, which preserves the grantor's GST exemption for other transfers. Funds in the HEET can be used to pay for education expenses at any level. The HEET is particularly effective for philanthropic-minded donors.

HEETs can only be used for direct payment of tuition or medical expenses. Expenses such as room, board, books, and related expenses are not excluded from GST tax liability. Also, the mandatory charitable distribution from the trust must be significant, thereby potentially reducing the amount of trust property available for the family.

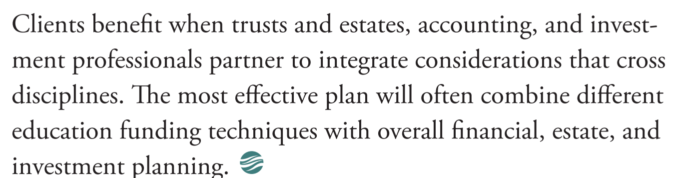
The HEET can be structured as a grantor trust. Therefore, the grantor can be eligible to receive a charitable income tax deduction for the amount distributed by the trust to a charity. After the grantor's death, the trust will be treated as a separate taxpayer. The trust will be entitled to take the charitable income tax deduction for amounts distributed to a charity.[11]

Like a dynasty trust, a HEET is typically established for the benefit of multiple beneficiaries, with a trustee that determines, in its sole discretion, which beneficiaries will receive distributions and in what amounts. Therefore, a HEET's effect on financial aid eligibility is unclear.

Creating the HEET in a jurisdiction where trusts can last in perpetuity might be preferable since the intent of the grantor of a HEET is generally to benefit future generations of descendants indefinitely. If the HEET is structured as a separate taxpayer, payment of tuition expenses on behalf of the trust beneficiary may result in an income tax liability to the beneficiary if the charitable distributions have not exhausted all of the trust's distributable net income.

MAKING EDUCATED CHOICES

Clients benefit when trusts and estates, accounting, and investment professionals partner to integrate considerations that cross disciplines. The most effective plan will often combine different education funding techniques with overall financial, estate, and investment planning.



11 I.R.C. § 642(c).

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