Summer 2019

Estate Planning Update Summer 2019 - Paying for Grandchildren's College Education

Given the spiraling costs of education, many families are realizing that careful planning and long-term strategies are no longer optional. The good news is that several tax breaks can allow families to combine their goal of saving for education with their estate and tax planning goals.

Qualified Tuition Programs

Qualified tuition programs (otherwise known as 529 plans) are the most commonly known option for college savings. Named after the Internal Revenue Code section that authorized them, 529 plans are sponsored by states or educational institutions. The growth on money invested in these plans is free from federal and state taxes, and withdrawals for "qualified higher education expenses" (generally, tuition, room and board, books, and fees for college, graduate or vocational school) are free from federal income taxes and may also be free from state income taxes. Beginning in 2018, families may also use 529 plans to pay for up to $10,000 (per year, per child) in tuition expenses at private, public and religious elementary and secondary schools. In addition, more than 30 states and the District of Columbia offer a state income tax deduction or credit for 529 plan contributions for college expenses, and 21 states offer a state income tax deduction or credit for 529 plan contributions for K-12 tuition.

Contributions to a 529 plan can be "front-loaded" by making five years' worth of annual exclusion gifts in a single year to help fund a grandchild's education. For example, each grandparent may contribute $75,000 (5 x the $15,000 annual exclusion amount) for each grandchild this year. In completing their 2019 gift tax returns, the grandparents can elect to take into account the contribution that is in excess of this year's gift tax annual exclusion ratably over five years so that they do not consume any of their gift or generation-skipping transfer (GST) tax exemption. Importantly, if the grandparents make additional gifts to the grandchild during this five-year period, those gifts will likely consume some of their gift and GST tax exemption. Assuming the grandparents survive the five-year period, the gifted amount will not be included in their estates for estate tax purposes and they may front-load another round of 529 plan contributions.

Direct Payment of Tuition to Educational Institutions

Another option for grandparents is the unlimited gift and GST tax exclusion for the direct payment of tuition to their grandchild's school (including private K-12 schools as well as college and graduate schools). Since this is an unlimited exclusion, it can be combined with contributions to a 529 plan, as mentioned above, or gifts to a grandchild's trust, a dynasty trust or UTMA account, as mentioned below. This unlimited exclusion applies only to direct payments of tuition to the educational institution.

Grandchildren's Trusts

A grandchild's trust (otherwise known as a 2642(c) trust) is a form of trust commonly used by grandparents who wish to make annual exclusion gifts to a grandchild over a period of years that also qualify for the GST tax annual exclusion. In order to qualify as a 2642(c) trust, the trust must be solely for the benefit of one grandchild during his or her life, and the trust must be drafted in such a way that the assets of the trust are includable in the grandchild's gross estate for estate tax purposes if the

grandchild dies before the trust terminates. The trust assets may be used for the benefit of the grandchild, including the payment of such grandchild's educational expenses.

Dynasty Trusts

If grandparents find that creating a separate trust for each grandchild is untenable, they could consider making gifts to a "dynasty trust" (with or without withdrawal powers designed to qualify gifts for the gift tax annual exclusion) and allocating their GST tax exemption to their transfers to the trust. Unlike a grandchild's trust that can have only one beneficiary, a dynasty trust can have several beneficiaries. While this option would consume some or all of the grandparents' GST tax exemption, it offers more flexibility and simpler administration. Given the current $11.4 million per person exemptions for gift, estate and GST tax purposes, conserving the GST tax exemption may not be the most important factor.

Health and Education Exclusion Trusts

Grandparents who have consumed their GST tax exemption and/or have charitable intent could consider a Health and Education Exclusion Trust (HEET). If a child or a charity, in addition to grandchildren, has a "significant" interest in the HEET, GST tax exemption need not be allocated, and distributions to educational institutions for the payment of tuition for grandchildren would not create a GST taxable event.

UTMA Accounts

Finally, custodial accounts under the Uniform Transfers to Minors Act (UTMA) of a state are perhaps the easiest way to give money to a grandchild that could be used to pay the grandchild's education-related expenses. Each grandparent can make annual gifts up to the gift tax annual exclusion of $15,000 to an UTMA account for their grandchild, and the gifts will qualify for the gift and GST tax annual exclusions.

Until the grandchild reaches the age specified under state law, typically age 21, the custodian may use the funds in the UTMA account for the grandchild's benefit. Once the grandchild reaches the age specified under state law, the grandchild will receive full ownership of the account.

One drawback of UTMA accounts is that, after a consistent stream of annual exclusion gifts, UTMA accounts often accumulate significant wealth that the grandchild may not have the maturity to invest and conserve upon reaching the age specified under state law. In some states, including Connecticut and Florida, statutory authority allows the custodian to transfer the funds from the UTMA account to an irrevocable trust for the grandchild, avoiding direct control. In states without such statutory authority, the grandparents or parents of the child can try to persuade the child who receives the funds on termination of the account to transfer the funds to a trust that limits the child's control of the funds.

Another drawback is that the UTMA account lacks the income tax advantages of a 529 plan. The income of the UTMA account is taxable to the grandchild and, under the current version of the "kiddie tax," the tax rate is determined using the compressed brackets applicable to trusts.

Financial Aid Considerations

Many of the options listed above could affect a grandchild's ability to qualify for financial aid for college. If financial aid is a concern, we recommend consulting college advisors to determine the possible impact of these accounts and trusts.

Grandparents considering one or more of these options should consult their Day Pitney attorney about which options are best for their families and how they can be coordinated with their other estate planning goals.