

Maximizing Gifts to Finance Education

By: Richard J. Shapiro, J.D.

It's no secret that the cost of a college education keeps rising at a rate greater than inflation. At the same time, people in increasing numbers recognize the need to prepare a well-designed estate plan.

Fortunately, families now have a variety of ways to make gifts for their loved-ones' education, often with significant estate, gift or income tax advantages. Here is a summary of some helpful strategies:

529 plans

Congress created these vehicles a few years back to encourage families to save for education. In 2001 Congress provided additional tax-saving "goodies" which have fueled the popularity of these plans. You can open a 529 plan as established by a state (virtually all states now have one or more plans in place), with total permissible contributions exceeding \$225,000 per beneficiary in many states. 529 plans are often established for the benefit of a child or grandchild, but the permitted family beneficiaries can include nieces, nephews, or others specified in the Statute.

The investment in the 529 plan grows free of Federal income tax, and New York residents who use New York's plan administered by TIAA-CREF will in most cases receive a state income tax deduction. Also under current law, distributions for qualified educational expenses are withdrawn *tax-free* (caveat: this benefit will expire in 2010 unless extended by Congress).

As an additional bonus, an annual gifting program may be "frontloaded" so that up to \$55,000 per beneficiary can be made free of gift tax in the first year, as opposed to the usual annual gift limitation of \$11,000 per beneficiary. This feature can be dynamic for clients with larger estates with a number of grandchildren who wish to reduce or even eliminate gift and estate taxes while at the same providing for the educational needs of loved ones.

While such contributions are deemed completed gifts for purposes of the tax code, the plan owner (i.e. parent or grandparent) retains the power to change beneficiaries at any time to any other family beneficiary (i.e., another child or grandchild).

What if your child decides not to go to college? Well, you can always designate another family-member beneficiary for the plan. If there is no one available -- or you just want the money -- withdrawals for non-educational purposes will be subject to a 10% penalty on the earnings, but there is no penalty on the principal you contributed.

Coverdell Savings Accounts

These vehicles, commonly known as the “Education IRA,” allow you to make up to a \$2,000 annual non-deductible contribution to a specially designated investment trust account. The account grows free of federal income taxes, and withdrawals are tax-free as well. Unlike the 529 plans, there are income limits for eligibility purposes, so not everyone can qualify to open a Coverdell account. Also, unlike 529 plans, the Coverdell account must be distributed to the beneficiary when he or she reaches age 30.

Section 2503(c) minor’s trusts

These irrevocable trusts permit a person to make contributions that qualify for the annual gift tax exclusion. Ordinarily, gifts to a trust that does not provide immediate access by the beneficiaries to the funds are deemed gifts of a “future interest” and are not eligible for the annual gift tax exclusion (currently \$11,000 per person). The 2503(c) trust allows for the implementation of a controlled gifting program whereby a person (often a grandparent) makes contributions to the trustee (often the parent) for the benefit of the grandchild. The parent may use the funds in the trust for the health, education, maintenance and support of the child. To qualify the gifts for the gift tax exclusion, the trust must either provide that the child retain an unlimited right to *compel* distributions from the trust at age 21, or a more limited window after the child reaches 21 in which the child may compel distributions. As an added bonus, assets in a properly drafted trust are protected from the beneficiaries’ creditors.

GST-Exempt Demand-Right trusts

These specialized irrevocable trusts allow you to establish a trust that will hold funds for your grandchildren's education. Ordinarily, gifts to grandchildren are subject to a Generation Skipping Tax (“GST”), except to the extent you allocate some or all of your lifetime exemption (currently \$1,120,000 per person). With these trusts, your children can be the trustees, or you can appoint a third party such as a bank or trust company. Each year you and your spouse can contribute the annual exclusion amount to each grandchild. The trust can be designed to establish a separate account for each grandchild. In this manner each grandchild will have a set amount of money for his or her education, and the gifts qualify for the annual exclusion and are not considered to be Generation Skipping Tax transfers. Thus you get the best of both tax worlds: no gift tax and no GST tax.

The trust can provide for the distribution of any funds not used for education in the manner *and* at the age that you feel is appropriate. In fact, you can be pretty much as creative as you want in the trust's instructions, ensuring that you can leave a lasting legacy for your grandchildren. It is very important, however, that you work with experienced advisors, especially your attorney, so that the terms of the trust allow for use of the annual exclusion for gifts and for GST transfers.

Like the 2503(c) trusts, gifts to the GST-Exempt Demand-Right trusts are protected from the beneficiaries’ creditors.

Unlike 529 plans or Coverdell IRA's, there is no requirement that the funds in either a 2503(c) trust or GST-Exempt Demand-Right trust be used solely for educational purposes. On the other hand, there are no special income tax breaks with these trusts. In most cases, the trust is drafted so that the grantor of the trust (i.e., the grandparent) pays the income taxes on the trust earnings, thereby allowing the assets in the trust to grow without diminution for income taxes.

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