BESSEMER TRUST

A Closer Look

Tax-Smart Approaches to Funding Education

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In Brief

- **College costs have been rising for decades. Adjusted for inflation, in-state tuition and fees for public colleges, for instance, have more than tripled in the past 30 years, and similar trends can be seen for private colleges and even independent primary and secondary schools.**
- **Parents, grandparents, and others often want to provide education funding for children, grandchildren, or other young people in their lives. Given the significant costs of an education that could potentially extend from pre-K through college, what is the most tax-efficient way to provide financial assistance?**
- **In this *A Closer Look,* we explore the potential benefits and drawbacks of several popular approaches to education funding.**

Everyone knows that college is expensive. In fact, it's been growing steadily more expensive for decades, even adjusted for inflation, and the trend is likely to continue. The same is true for independent primary and secondary schools.

Maybe you're a parent looking ahead to four — or possibly many more — years of tuition bills for your children. Or a grandparent who wants to shoulder some (or all) of these costs for your grandchildren. Or an aunt, uncle, or really anyone looking to help a young person with school tuition and expenses.

Even when these costs are readily affordable, they are substantial enough to warrant consideration from a wealth planning perspective.

What is the most tax-efficient way to pay for school expenses? What options are available, and which of them make the most sense for you? In this *A Closer Look,* we explore the potential benefits and drawbacks of several of the most popular and tax-efficient approaches to providing educational funding for children, grandchildren, and others, specifically considering the impact of federal transfer (estate, gift, and generation-skipping) taxes.

Direct Payment of Tuition

The most straightforward approach is simply to make tuition payments directly to the school, whether a primary, secondary, or post-secondary (college or university) institution. This can often make good sense for parents — and also grandparents who reasonably expect to be living when their grandchildren are attending school.

The main advantage here is that there is a gift tax exclusion for tuition payments, and it's unlimited. Anyone — parents, grandparents, uncles, aunts, other family members, and friends — can pay anyone's tuition without any gift tax implications. In other words, these payments do not count against your annual gift tax exclusion or your lifetime gift tax exemption. (See Exhibit 1.)

In addition, for grandparents, there are no generation-skipping transfer (GST) tax implications. (See Exhibit 1.)

Importantly, these gift and GST tax advantages only apply to tuition — not room, board, and the many other costs of attending college. If you would like to lend a hand with these expenses, outright gifts of annual exclusion amounts can also be made to children or grandchildren (or others), who can then use the gifts to pay for college expenses such as room and board, etc., or you can pay such expenses on behalf of the child, grandchild, or other person you wish to benefit.

Exhibit 1: Gifts and Taxes — Key Terms.

When you give money (or property) to someone or pay expenses on behalf of another person and receive nothing in return, it is generally regarded as a gift for tax purposes. Gift taxes are assessed at a rate of 40%, and the donor (not the recipient) is responsible for paying them; that said, Congress provides a number of exclusions and exemptions to soften the impact of these taxes:

- **The annual gift tax exclusion.** Congress allows individuals to give a certain amount ($15,000 for individuals, $30,000 for married couples, in 2019 and 2020) per individual recipient each year free of gift taxes; in other words, this year, you could, say, give a gift of $15,000 to each of your four grandchildren ($60,000 total) without having to pay any gift taxes. If both you and your spouse choose to give those gifts together, the figure would double. This is known as the annual gift tax exclusion, and the exact amount is reviewed each year and periodically adjusted for inflation.
- **The lifetime gift tax exemption.** In addition to the annual gift tax exclusion, you also have a lifetime gift tax exemption, which is the total amount (currently $11.4 million for individuals and $22.8 million for married couples, and $11.58 million and $23.16 million in 2020, respectively) you can give away tax-free in your lifetime. Note that the gift tax exemption and estate tax exemption refer to the same pool of exemption, so lifetime use of the gift tax exemption does reduce the exemption available for transfers at death.
- **The annual exclusion and lifetime exemption work separately from each other.** If you were to give your child $100,000 this year, for instance, $15,000 would fall under the annual exclusion, and the balance ($85,000) would fall under the lifetime exemption, assuming that you have sufficient exemption available.
- **The generation-skipping transfer (GST) tax exemption and annual exclusion.** Another transfer tax worth noting, particularly for grandparents, is the generation-skipping transfer (GST) tax. In general, it applies to gifts to grandchildren (and succeeding generations) — or any nonrelative at least 37½ years younger than the person providing the gift. However, the IRS allows for an annual GST exclusion (currently $15,000 per recipient) and a lifetime GST exemption (currently $11.4 million, and increasing to $11.58 million in 2020).
- **Gift tax exclusion for direct payment of medical and educational expenses.** Payments, regardless of their amounts, for medical care made directly to the provider and payments of tuition (but not other educational expenses) made directly to an educational institution are not regarded as taxable gifts and so have no impact on the annual gift or GST tax exclusions and the lifetime gift or GST tax exemptions.

From an estate planning standpoint, making annual gifts to an individual, as well as making direct payments of tuition for that individual, can be an efficient method of transferring meaningful amounts free of gift, estate, and GST taxes. However, this may be a long-term plan, and depending upon one's age and health, there could be a risk of one's death occurring prior to the payment of all the tuition bills. (Other techniques, discussed below, allow you to set aside funds for future college expenses.)

If you're a grandparent of a young child, for example, and you're concerned that you won't live long enough to pay each year's tuition, it is possible to prepay tuition directly to a school — without incurring any gift tax or GST tax. If three of your grandchildren are in school, for example, you could pay the tuition in advance for their remaining years until graduation — with no gift tax or GST exclusion or lifetime exemption implications and also remove the assets from your taxable estate now (see Exhibit 2). The one potential catch here is that prepayments of tuition must be nonrefundable, even if the students fail to attend or leave the school for any reason.

Custodial Accounts

Custodial accounts — also referred to as UGMA (Uniform Gifts to Minors Act) or UTMA (Uniform Transfers to Minors) accounts for the legislation that established them — offer another education funding approach that can be effective for some people.

Custodial accounts offer a number of advantages:

- Compared with trusts, opening and managing a custodial account is simpler and less expensive.
- Contributions can take advantage of the gift tax annual exclusion and, for grandparents, the GST tax annual exclusion.

- Once open, anyone (parents, grandparents, other relatives, and friends) can make unlimited contributions, though contributions exceeding the annual exclusion will either use exemption or cause gift (and possibly GST) tax if no exemption remains available.
- Unlike 529 plans (discussed below), which only accept cash, you can contribute many different types of assets to custodial accounts. UTMA accounts can generally accept any asset type, including real estate, fine art, and royalties; UGMA accounts are usually limited to financial assets — cash, securities, annuities, and insurance policies.
- The custodian can control how the money is invested while the beneficiary of the account is a minor.

That said, custodial accounts do have several potential drawbacks:

- Contributions are irrevocable, and the funds must be used exclusively for the benefit of the minor, who legally owns the funds (even if they're controlled by the custodian).
- The beneficiary of a custodial account cannot be changed.
- Since the fund's assets belong to the minor, so do the income tax obligations; income above a certain amount can result in a higher tax hit — as it can trigger the "kiddie tax."
- When your child is considered an adult (ranging from age 18 to 21, and occasionally up to 25 by election, depending on the state of residence), the money automatically becomes his or hers, and the custodian no longer has any legal right to control the account.

While custodial accounts are easy to establish, they are not always as simple as they seem at first glance, and when it comes to education funding, there may be better options, especially given the mandatory handover of control when the child becomes an adult.

State-Sponsored 529 Plans

Named after the section of the Internal Revenue Service tax code that authorizes them, 529 plans are tax-advantaged tuition savings plans. They are sponsored by individual states, with most states sponsoring them, but their specifics can sometimes vary.

Exhibit 2: Paying Tuition Outright.

The tuition cost for Bob and Mary's granddaughter, Emma, to attend university is $50,000 per year.

They pay her tuition costs to the school directly. Because of the gift tax exclusion for tuition expenses, they don't pay any gift or GST taxes — and they don't use up any of their annual exclusions or lifetime exemptions.

They then give Emma $30,000 ($15,000 annual exclusion x 2) each year to cover her other educational expenses, such as room and board and books.

In the end, they are able to effectively give Emma $80,000 per year without having to pay any gift or GST taxes — and without using any of their lifetime exemptions.

There are two types of state-sponsored 529 plans:

- **529 savings plans** work like retirement plans; 529 savings plans can generally be used for "qualified educational expenses" for post-secondary school education (e.g., college, graduate school, or vocational school). The 2017 Tax Act added flexibility by expanding permitted 529 saving plan distributions to include up to $10,000 per year toward the beneficiary's K-12 tuition. Contributions are invested through certain state-endorsed investments, and they offer a number of benefits:
  - Contribution amounts can be excluded from gift tax up to the annual exclusion amount; in addition, it is possible to make a five-year upfront contribution ($75,000 for a single donor and $150,000 for couples) per beneficiary and thereby increase the appreciation potential of your account. This would mean, however, that you would not be able to give annual exclusion gifts to that recipient, including making contributions to a 529 plan, in the four years following the contribution, and also requires the filing of a gift tax return relating to the year of contribution.
  - Contributed funds grow free from federal income tax (and sometimes state income taxes as well) and so have the potential to grow at an enhanced rate.

- Withdrawals are free from federal income tax (as well as state income tax, in most states) if they are used to pay for most educational expenses, including tuition as well as room, board, textbooks, computers and software, and similar expenses.
- You do not have to purchase a plan in your own state, but there may be tax advantages for doing so (for example, some states allow residents to take a state income tax deduction for contributions to their own state's plan).
- Once open, anyone (parents, grandparents, other relatives, and friends) can make unlimited contributions, though contributions exceeding the annual exclusion will either use exemption or cause gift (and possibly GST) taxes if no exemption remains available.
- Each state enforces a specific total contribution limit. These typically range between $300,000 and $500,000 per beneficiary.
- You may transfer the plan to another family member within the same generation without tax penalties.

Among the potential drawbacks:

- Only cash can be contributed.
- Assets in 529 savings plans are generally subject to market risk, though there are some FDIC-insured 529 savings plan options that provide a low, but guaranteed, rate of return.
- You must choose only from a limited number of state-sponsored investment options, and you can only make investment selection adjustments twice per year (or when there is a change in beneficiaries). One rollover from a 529 savings plan for a particular beneficiary to another 529 savings plan for the same beneficiary is permitted each year.
- If you withdraw funds for anything other than educational expenses, you will pay federal income tax on the earnings, if any, plus a 10% penalty (except in the cases of student death, disability, or the receipt of a scholarship). There may also be additional state and local income taxes and penalties.

- **529 prepaid tuition plans** are less common than savings plans (fewer states have offered them, and of those, many plans are closed to new participants), but they may be an option worth considering:
  - Prepaid tuition plans allow parents, grandparents, and others to prepay tuition at today's tuition rates at eligible public and private colleges/universities, and most states guarantee that the funds you put into a prepaid plan will keep pace with tuition.
  - You can pay in one lump sum or in installments.
  - Prepaid tuition plans typically have contribution limits based upon the current cost of four years of in-state public colleges.
  - Most prepaid plans let you transfer the plan to another child (although age restrictions may prevent transfers to an older sibling).

  The potential drawbacks:

  - Prepaid plans offer no investment options.
  - Most prepaid tuition plans require residency by the plan owner or beneficiary in the state that sponsors the plan.
  - Most prepaid tuition plans cover tuition only; they do not cover other educational expenses, such as room and board.
  - In most cases, if your child attends an in-state public college, the plan will pay full tuition costs. If your child attends a private college or out-of-state college, the plan will only pay the average of the in-state public college tuition.
  - Any funds not used for educational expenses are subject to taxes and penalties.
  - If you need to close your account, most plans will only give you back what you originally contributed and will reduce or eliminate any interest earned. Some charge a cancellation fee.

529 plans can be appealing for their simplicity and income tax advantages, and are often part of a family's overall education plan. Clients appreciate that they can set one up without a lawyer's involvement. However, given their limitations, they are not typically the exclusive approach that Bessemer clients use when considering funding education.

Educational Trusts

Trusts offer tax-efficient and flexible education funding opportunities since they can be used for things other than education — such as a down payment on a house or starting a business — without incurring any of the penalties associated with 529 plans.

In this section, we focus on several of the most popular and tax-efficient trust structures suitable for education funding. Both parents and grandparents (and others) can use them, but they are particularly suitable for grandparents because they are among the few trust types that are designed to qualify for GST annual exclusion gifts.

More specifically, the following strategies focus on gift and GST annual exclusion gifting. For those who want to use their lifetime exemption, other trust structures may be appropriate. Most trust structures offer flexibility in the purposes for which distributions can be made, including for the beneficiary's education.

Section 2503(c) Minor's Trust

Unlike most other trust structures, the Section 2503(c) minor's trust (like the 529 plan, named for the tax code section it's based on) allows a parent or grandparent to take advantage of the gift and GST exclusions if certain conditions are met:

- The trust must have only one beneficiary.
- Trust principal and income must be used exclusively for the benefit of the minor.
- When the beneficiary turns 21, he or she must be given the option to withdraw any remaining trust assets (unlike a UTMA account, where the beneficiary has legal control upon attaining the terminating age). The trust can be structured so that the beneficiary will have a period of time (say, 30 or 60 days after reaching the age of 21) to withdraw the assets; if the beneficiary does not choose to do so, the assets will remain in the trust.
- If the beneficiary dies while the trust is in existence, the trust assets will be included in his or her estate.
- Gifts to the trust are irrevocable.
- Trust funds can be used for any purpose permitted under the trust document, which would typically include distributions for education.

In addition to the gift and GST exclusions, the main benefit of a minor's trust is trustee control of trust assets until the beneficiary turns 21. There is no requirement for withdrawal notices after contributions (as with Crummey trusts, discussed below), and if used to pay for college expenses, virtually all of the trust assets could be gone by the time the beneficiary turns 21.

The minor's trust does have a number of potential drawbacks that should be considered:

- As with custodial accounts, the inability to control the use of funds beyond a certain age is a potential drawback of the minor's trust, particularly if the trust assets are sizeable and intended for more than educational purposes. Parents and grandparents are often understandably uncomfortable providing a 21-year-old with (potentially) a huge windfall.
- Another possible drawback is income tax — earnings on trust assets are taxed to the trust if they're not distributed to the minor beneficiary in the year they are earned, and trusts generally have less favorable income tax treatment compared with individuals. Distributions made to a beneficiary or for a beneficiary's benefit (including to fund education) will "carry out" income tax liability to the beneficiary, to the extent of the trust's income in a given year. If, however, you structure it as a "grantor trust," you (the donor), rather than the trust or the beneficiary, will have to pay the income tax at your rates (while the beneficiary is a minor) from your personal assets, thereby effectively increasing your gift to the beneficiary.
- Any contributions to the trust after the beneficiary turns 21 will not qualify for annual exclusions (unless Crummey trust provisions are included, see below).

Is a minor's trust right for you? Some parents are (understandably) uncomfortable about providing their 21-year-old children — most of whom will have yet to complete their college educations — with access to what could well be a sizeable sum of money.

Others are confident their children will act responsibly and not withdraw funds. In our experience, most of the time, beneficiaries do not withdraw trust funds. And

Exhibit 3: Education Funding Approaches — Key Features.

Direct Pay.

- Most straightforward funding method.
- Unlimited cash payments for tuition only (not other school expenses) are free from gift and GST taxes; no impact on annual gift tax exclusion and lifetime exemptions.
- Most suitable for parents and those more likely to be alive when student attends school.

Custodial Accounts.

- Easier and less expensive to establish than trusts.
- Contributions (most asset types accepted) can take advantage of the gift and GST tax annual exclusion.
- Custodian controls investment decisions while beneficiary is a minor.
- Distributions not limited to education but must be used exclusively for the benefit of the minor beneficiary.
- Mandatory transfer of account assets to beneficiary upon attaining the age of maturity.

529 Savings Plans.

- Easier and less expensive to establish than trusts.
- Funds can be used for "qualified educational expenses" for post-secondary education (tuition, room, board, etc.) and up to $10,000/year for K-12 tuition.
- Contributions (cash only) can take advantage of the gift tax annual exclusion and, for grandparents, the GST tax annual exclusion. Five-year upfront contributions are possible.
- Limited investment options.
- Contributed funds grow free from federal (and sometimes state) income tax.
- Withdrawals are free from federal (and most state) income and capital gains taxes if used to pay for education, including tuition and other school expenses.
- Funds not used for education are subject to income taxes and penalties.

529 Prepaid Plans.

- Allow for prepayment of tuition only at eligible public and private colleges; most states guarantee that funds will keep pace with tuition.
- No investment options.
- Most plans require in-state residency by the plan owner or beneficiary.
- If child attends a private or out-of-state public college, the plan only pays average of in-state public college tuition of the state sponsoring the plan.
- Funds not used for education are subject to taxes and penalties.
- If account closed, generally only original contribution (not interest earned) is returned.

Minors' Trusts.

- More complex to establish than custodial accounts and 529 plans, but also more flexible.
- Contributions (most asset types permitted) eligible for the gift tax and GST annual exclusion.
- Trustee controls all assets until beneficiary turns 21.
- Funds can be used for any purpose, including education, but exclusively for the benefit of the minor beneficiary.
- Income on trust assets is taxed to the trust (if not distributed to beneficiary in year earned).
- Potential drawback: At age 21, beneficiary must be given option to withdraw all trust assets.

Crummey Trusts.

- Similar to the minor's trust in terms of gift/GST tax exclusions, trustee control of assets, income tax treatment.
- Unlike the minor's trust, there is no mandatory termination or right to withdraw all assets at age 21.
- When a gift is made to the trust, beneficiary receives written notice of temporary right to withdraw it. If not withdrawn during this period, it becomes the trust's property.
- Each notice applies only to most recent gift, not entire trust.
- Parents can sign off on annual notices until beneficiary turns 21.
- Trust funds can be used for education or other purposes.

Health and Education Exclusion Trusts (HEETs).

- Complex to establish, and there is the possibility that their use will be limited by future legislation.
- HEETs allow for payment of tuition and medical expenses for beneficiaries, potentially for multiple generations without requiring use of GST exemption.
- Must have a charity as co-beneficiary.

in cases where the trust document does not provide for the option for the trust to continue beyond age 21, parents will often encourage their children to set up another trust for their own benefit (sometimes called a "voluntary trust" or a "self-settled trust") where they deposit funds from the original minor's trust and which often provide for staged distributions. In most instances, they will also allow for the trustee (typically one of the parents) to make discretionary distributions as well.

While the minor's trust can be useful, and it does remain a popular option, its appropriateness really depends on individual family circumstances.

Crummey Trust

Apart from the minor's trust, gifts to trusts generally do not qualify for the annual gift tax exclusion since the beneficiary does not have a "present interest" in the trust — that is, the beneficiary has no current right to enjoy the trust assets. However, if you give the beneficiary the right to withdraw each new addition to the trust (even if it's a temporary right as short as 30 days), the beneficiary will be deemed to have a present interest in the trust, and the annual gift tax exclusion will apply.

This is known as a Crummey trust, named after D. Clifford Crummey, who established the legality of this technique in a landmark U.S. Court of Appeals case in 1968.

When a new gift is made to the trust, the beneficiary receives a written notice of his or her right to withdraw it (known as a Crummey notice). If the beneficiary does not withdraw the gift during the withdrawal period (often 30 or 60 days), the contribution becomes the property of the trust, and the beneficiary can no longer withdraw the contributed trust property.

Additional features of the Crummey trust:

- Each Crummey notice applies only to the most recent gift (not any previous years' contributions). The beneficiary can only withdraw the annual contribution — not the entire trust. In practice, most beneficiaries do not exercise their right to withdraw since they know that it would most likely eliminate any future contributions.
- If the beneficiary is a minor, a parent can receive and sign the withdrawal notice on behalf of the beneficiary.
- Gifts to the trust qualify for the annual gift tax exclusion.
- For grandparents, for the GST annual exclusion to work, there must be only one beneficiary of the trust, and whatever assets are in the trust must be included in the beneficiary's estate when he or she dies.
- Unlike the minor's trust, which has a mandatory termination at age 21 (unless structured to provide a temporary period of time to withdraw all of the trust's assets), Crummey trusts can continue unchanged beyond the beneficiary's 21st birthday — although the then-adult beneficiary (rather than the parents) would receive and sign off on any notices of additional contributions.
- Earnings on Crummey trust assets are taxed in the same way as earnings on minor's trust assets (see page 5).
- Trust funds can be used for college expenses or other purposes — without penalties.

At Bessemer, while clients continue to use minors' trusts and find them effective, many tend to be more comfortable with a Crummey trust. While minor beneficiaries do have the temporary right to withdraw funds from a Crummey trust every year, it's limited to the value of the most recent gift, and so it's likely to be no more than the annual exclusion amount; many parents find this to be a less risky alternative than entrusting their 21-year-old child with the right to withdraw all of the trust's assets.

Health and Education Exclusion Trust (HEET)

As we noted above, the most straightforward (and gift and GST tax-efficient) way for grandparents to pay for their grandchildren's educational expenses is to pay schools directly, but this method only works while the grandparents are living.

Grandparents who want to pay the school tuition for grandchildren and succeeding generations (with tax advantages), and who also happen to be charitably inclined, might consider a health and education exclusion trust (HEET), a dynasty trust that allows

you to pay tuition and medical expenses for trust beneficiaries — with no limits on the amount that can be paid. It can be established during your lifetime or upon your death.

Importantly, you can use your lifetime exemption to make contributions free of gift taxes, thereby removing the assets (and any future appreciation) from your estate.

Contributions should not incur any GST tax (or require use of the GST exemption) as long as the trust has a charitable beneficiary and distributions are limited to direct payments to schools (for tuition only) and medical care providers for beneficiary healthcare expenses.

Moreover, if your HEET is structured as a grantor trust, you can receive a charitable deduction at the time distributions are made from the trust to charity.

That said, HEET trusts are complex and have little in the way of authority (in the form of cases or IRS guidance) to support their use. It seems clear that the charitable beneficiary must be a beneficiary of substance — that is, a beneficiary more than in name only — and must receive meaningful distributions. However, there are no guidelines for what type of interest the charitable beneficiary should have. Some practitioners believe that 10% of trust income is sufficient to establish a significant interest, while others peg the number much higher — at as much as 50% of trust income along with a portion of trust principal. HEETs are not based on specific tax law; rather, they were developed by reading multiple sections of the tax code in combination. In addition, these trusts have received some negative attention from the authorities. The fiscal year 2016 revenue proposals by the Obama Administration called for a change to the statute that permits GST nonexempt trusts to make distributions for tuition and medical expenses without GST consequences. If enacted, such a change would effectively eliminate the use of HEET trusts on a going-forward basis, and it is unclear if existing HEET trusts would be able to continue to make distributions for noncharitable purposes without negative tax consequences.

What Funding Strategy Is Best for You?

Providing for a young person's education is a meaningful gift, but there are many ways to do so, and no single approach is right for everyone. In fact, for many people, a combination of approaches can often make the most sense. If you'd like to explore your education funding options, Bessemer's tax and estate planning professionals are available to help you assess the most appropriate method or methods for you based on your particular personal, tax, and estate planning goals.

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