

# **FUNDING EDUCATIONAL NEEDS OF CHILDREN AND GRANDCHILDREN**

This memorandum summarizes several potential methods for funding the educational needs of others.

## **1. Outright Gifts.**

Every individual can give up to \$11,000 annually to any one or more persons without any gift or estate tax consequences. This is called the “annual exclusion from gift taxation.” Accordingly, money can be funneled to children or grandchildren for educational purposes by making outright gifts to the individual over a period of years. However, such gifts must be made with “no strings attached,” meaning that such gifts will be used for the educational needs of the recipient only if the recipient agrees to use the gift for such purposes. Gifts such as these are frequently made to custodial accounts (see paragraph 2).

## **2. Custodial Accounts.**

The Oregon Uniform Transfers to Minors Act (UTMA) provides a convenient means to transfer property for the benefit of a minor, while permitting limited control over the gifted assets. The donor completes a simple form naming the minor as beneficiary of the custodial account and naming an adult as custodian. Unlike a trust, the custodial account terms and provisions are specified by statute (rather than by agreement). Despite the delayed payout of a custodial account, gifts made under the UTMA qualify for the \$11,000 annual exclusion from gift taxation. Furthermore, UTMA custodians are free of court supervision, bond, and other accountability (except to the beneficiary and his or her representative).

Simplicity is the major benefit of the UTMA custodianship, which makes it useful and cost-efficient for modest gifts to a minor. However, when a larger amount of property is involved, a trust (see paragraph 6) is usually the better choice for the following reasons: (i) a custodial gift must be distributed to the beneficiary no later than when the beneficiary attains age 21; (ii) if the minor dies before reaching the distribution age, the custodial assets must pass to the minor’s estate (and, because the donor cannot control distribution upon the minor’s death, probate is required); and (iii) the donor cannot specifically control the manner in which the custodial account assets are utilized following the distribution of the account when the beneficiary attains age 21. Conversely, a trust document can provide for a successor trustee’s method of changing trustees, contingent beneficiaries, and can provide specific direction on the purpose or purposes for distributions to be made from the trust.

## **3. Direct Payments to Educational Institutions.**

An individual’s payment of another’s academic tuition to an educational organization is excluded from federal gift tax, regardless of whether the individual has any obligation to make

such payment (e.g., a parent's duty to support his or her children). Such transfers fully escape the gift tax without consuming any part of the individual's annual exclusion from gift taxation. Educational expenses that may qualify are unlimited in amount. However, payments may only be made for "tuition." Payments for books, supplies, housing, and related items are outside the statute and will constitute taxable gifts (to the extent that the payment exceeds \$11,000 (or \$22,000, for gifts by spouses) during any calendar year). To be excluded from gift tax consequences, payment for another's academic tuition must be made directly to an educational organization.

#### **4. Tax-Deferred College Savings Plan.**

Many states have adopted tax-deferred college savings plans through which an individual may contribute an after-tax amount annually, thereby completing a tax-free gift to the beneficiary of the account (called a "section 529 plan"). Each donor may contribute up to \$11,000 annually and a donor can immediately contribute \$50,000 into a college savings account and have that amount counted toward the next five years of annual exclusion gifts. The benefit of this is that the future appreciation on that amount is out of the donor's estate currently. Each plan sets its own total contribution limit, but many plans allow contributions of up to \$100,000 or more.

The donor simply deposits money into a state-sponsored mutual fund. Once deposited, the fund will grow on a tax-deferred basis until withdrawn to pay for college tuition, books, room or board. Earnings on the fund are taxed at the student's tax rate when distributions are made. Invested funds from a section 529 plan can be withdrawn to pay for the beneficiary's college expenses, including tuition, books, fees, and supplies. They can also be used for certain room and board expenses. Currently, qualified withdrawals are taxed at the student's tax rate, which may be lower than the investor's tax rate. Beginning in the year 2002, qualified withdrawals from state-run plans are tax-free. Beginning in the year 2003, this tax-free status extends to plans run by educational institutions (including private ones) as well.

Unlike custodial accounts and education IRAs (see paragraph 5), the donor retains significant control over the funds even after the beneficiary is no longer a minor. If the beneficiary decides to forgo college, the donor can generally change the beneficiary or roll the money into a section 529 plan account for another family member without losing the plan's tax benefits.

Section 529 plans offer a tax-advantaged way to save for college, but they are not the right choice for everyone. For example, investments in section 529 plans may adversely affect a student's ability to get need-based financial aid. Also, most states charge an annual management fee for section 529 plans and some charge enrollment fees, both of which can involve significant monetary expenditures, thereby reducing the growth of the fund. IRS rules do not permit an investor to direct investments. Because such plans are relatively new, investment choices may be limited. Finally, if the money is not spent for education, you will generally lose the tax benefits and incur a penalty.

## **5. Education IRAs.**

Beginning with tax year 2002, an individual may establish an IRA for after-tax contributions of up to \$2,000 per beneficiary per year that can be withdrawn tax free if used for designated higher education expenses. The \$2,000 annual limitation is reduced once the donor's adjusted gross income exceeds \$95,000 (\$150,000 for spouses filing joint returns). Contributions to education IRAs must be made in cash and no contributions generally can be made after the beneficiary attains the age of 18. If the beneficiary should die, the balance in the IRA account must be distributed within 30 days after the date of death to the estate of the beneficiary. Consequently, because of both the modest contribution limitation and the relatively low income limitations, education IRAs will be only of moderate use to highly compensated individuals.

Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. Room and board expenses that do not exceed federal financial aid guidelines are also qualified higher educational expenses for students attending at least one-half time.

Contributions to an education IRA are treated as completed gifts to the beneficiary and qualify for the \$11,000 annual exclusion from gift taxation, but are not treated as excludable qualified education transfers to an education institution. Because of this, it may be more advantageous from an estate and gift tax standpoint for individuals to directly pay educational expenses at the appropriate time because a greater amount can be transferred free of estate and gift taxes by such means. The distributions from an education IRA are not includable in the gross income unless they exceed the qualified higher education expenses of a designated beneficiary.

## **6. Irrevocable Education Trust.**

An individual can create an irrevocable trust for the benefit of any number of individuals and direct the trustee of the trust to make distributions from the trust only for specified purposes (e.g., tuition and other educational expenses). For such a trust, the annual exclusion from gift taxation is available by following certain rules requiring additional documentation. To the extent a gift to a trust beneficiary exceeds the annual exclusion amount (or twice that amount for gifts made by spouses) during any calendar year, the gift is subject to gift tax. However, any gift tax imposed can be offset by the donor's lifetime exemption equivalent amount (which is currently \$1,000,000).

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