CHAPTER 38

Providing Education and/or Nest Egg Funding for Young Beneficiaries

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You may be a parent or a grandparent planning to fund a child's or grandchild's college education. You may be an aunt, uncle, or adult mentor with a similar desire to help fund the education of your favorite young niece, nephew, or friend. What better financial investment, you are thinking, can you make in a child's future?

If that is your wish, you are in luck because there are many effective ways to accomplish your objectives and there are numerous tax benefits available that will enable you to do so in a tax-efficient way. There are so many alternatives, in fact, that your main challenge will be to determine which education-funding mechanism is most suitable to your circumstances. In a nutshell, your range of options includes direct gifts to or for the benefit of a minor, gifts to custodial accounts, gifts in trust, and gifts to Section 529 accounts. So how do you determine which strategy will work best for you?

First, it helps to understand the pros and cons of each form of education funding. Direct gifting to minors is very simple: you make out a check in the name of the child and deliver it to the child's parents and they deposit the check in an account in the name of the child. The downside of the strategy is that the child will gain control of the account upon attaining the age of majority in the state of his or her residence. There is a risk that the child will not use the gifted monies for education or other worthwhile purpose. If direct gifting is nonetheless desired, a better alternative might be to make a direct tuition payment to an educational institution for the benefit of a child enrolled there, and this technique could be used for pre-college private schools as well as for college funding. Such a direct tuition gift qualifies for the unlimited gift tax exclusion for tuition payments.

Custodial accounts, similarly, have advantages and disadvantages. Under most Uniform Gifts to Minors or Uniform Transfers to Minors Acts, the child will not gain unfettered access to the account until he or she attains age 21. Thus, in the many states that have an age of majority of 18, the custodial account will allow the account to stay out of the child's control a little longer than a non-custodial account, perhaps until the completion of the child's college education. But what if the account appreciates in value during the child's pre-college years and there is much more than is needed for the child's education? Or what if the child has qualified for significant grant or scholarship money or has elected not to go to college? Then the custodial account doesn't look as favorable because the child, who may not be financially responsible yet, may have access to a lot of capital at age 21. The child might waste the money on depreciating assets or frivolous pursuits. The child might decide not to seek employment and live off the capital.

If it is foreseeable that gifted monies will grow substantially over the child's pre-college years and exceed the amount required to fund the child's education, such that the monies will also create a future nest egg for the child, then trusts are usually the preferred funding vehicle. Specialized trusts designed to qualify contributions for the gift tax annual exclusion are typically used for this purpose. One such trust is usually dubbed a "Minor's Trust." It is a special form of trust described in Section 2503(c) of the Internal Revenue Code that qualifies for the annual exclusion. The problem with this form of trust is that the child for whom it is established must be given the right to withdraw all of the trust assets when he or she attains age 21. If the trust still holds a lot of assets at that time, then the same potential problems arise that exist with custodial accounts. Maybe the child will agree to allow the assets to continue to be held in a trust for his or her benefit, but there is always a risk that the child will opt to pull the assets out. Another possible disadvantage with this form of trust is that the trust instrument must require the Trustee to make distributions for the "best interests" of the child. The trust cannot be tailored for educational or more finely tuned purposes.

Because of the inherent drawbacks with Minor's Trusts, tax practitioners developed an alternative form of trust which enables contributions to qualify for the gift tax annual exclusion while allowing the creator of the trust to postpone the date at which the child can take possession of the trust assets. This form of trust is usually referred to as a "Crummey Trust," its name having been borrowed from the brave soul who litigated and succeeded in one of the early cases testing this type of trust's qualification for the gift tax annual exclusion. With such trusts, the beneficiary is given the power to withdraw contributions for a limited time (30 days for example) after a contribution is made to the trust. There is little risk that the withdrawal powers will be exercised while a child is a minor because only the child's parents (or guardians) can exercise the withdrawal rights. Once the withdrawal period passes, the property can be held in trust for the child's benefit for the time period the trust creator chooses, even for the child's lifetime or beyond (for a child's children or siblings, for example). Thus, this form of trust is especially useful if there is a chance that residual value above and beyond a child's education costs will build up over years. The trust instrument can be tailored to provide funding to the child for education and other desired purposes. Trusts such as the Crummey and Minor's Trusts are also very good creditor protection vehicles because they can be designed as discretionary trusts that do not give the child rights to income or principal that can be garnished or attached by a creditor or made part of a property settlement in a divorce.

The newest option in the planning arsenal is the Section 529 account, another device created in the Internal Revenue Code. This special kind of account is similar to an IRA account, but it is geared toward funding college costs. There are several unique characteristics which make a Section 529 account a special planning vehicle. First, if the account assets are used to pay for education costs, then the account's earnings (i.e., its income and gains) are not subject to federal income tax. Second, the initial account contributor can take back property by withdrawing it from the account. This makes it unlike any other kind of "gifting" strategy. Third, the account can be front-loaded with up to five times the amount of the gift tax annual exclusion ($60,000 in 2008, and $65,000 in 2009), or twice this amount for a married couple, if a special five-year election is made to treat the gift as though it were made over a five-year period. Fourth, the beneficiary can be changed after the account is established.

There are some drawbacks to Section 529 accounts, which should also be considered. First, the accounts can only be funded with cash. Thus, they are not suitable for contributors who wish to contribute closely held or publicly traded securities, land interests, or other non-cash assets. Second, if amounts are distributed from the account for anything other than education costs, such non-qualifying amounts are taxable to the recipient at ordinary income rates and a 10% penalty is imposed. Consequently, if a large portion of the assets would, upon sale, be otherwise taxed at capital gain rates, this would be disadvantageous. Third, your investment options are limited with Section 529 plans. Each state operates at least one of these plans and each of these plans typically uses one mutual fund family and offers no more than a half dozen investment choices within those mutual fund families. Typically, you can only make changes in your investment allocation once per year. Therefore, these accounts might not be suitable for you if you do not want to have your investment choices limited or believe that you can invest with greater success than the investment managers used by your state's Section 529 plans. A fourth drawback with these accounts is that a number of issues exist with these accounts that have not yet been settled by the Internal Revenue Service. Results are not as predictable as you might like them to be on issues such as what happens to an account upon the death of the account owner or upon the death of a beneficiary.

Given the myriads of education funding choices and their advantages and disadvantages, there are several conclusions that can be drawn about their relative suitability.

- First, if it is possible you will accumulate capital that significantly exceeds what will be required for a child's education, consider using a trust. This approach is especially beneficial if you have a sizeable estate and wish to shift wealth out of your estate to your children and grandchildren and if you intend to invest in assets with explosive growth potential such as stock in a company planning to go public. If, on the other hand, you anticipate that all of the funds will be used for a child's education, a Section 529 account may be the best option because of the tax-free growth such accounts afford. Trusts can adapt well to changed circumstances (such as the death of a beneficiary); Section 529 plans may not adapt as well. However, it is possible under some states' 529 plans to open a Section 529 account in the name of a trust, and that option may make such accounts in those states much more adaptable to change.

- Second, if you wish to get some of the funded money back, you will want to use a Section 529 account.
- Third, if you intend to contribute non-cash assets, trusts and custodial accounts are the only available choices.
- Fourth, if you want to invest the gifted monies yourself or hire your own investment manager, you will want to use a custodial account or a trust.
- Fifth, if creditor protection is of paramount concern, consider using a trust. However, some states have enacted spendthrift laws and other creditor protection measures for Section 529 plans (and some federal bankruptcy protection is available for 529 accounts). In those states, Section 529 plans may offer strong creditor protection as well.

Timothy M. Halligan has an estate planning practice that caters to families desiring to coordinate their personal tax and investment planning with their retirement and wealth transmission planning.

Comparison of Various Types of Transfers to Minors

	UGMA/ UTMA	SECTION 2503(B) TRUST	SECTION 2503(C) TRUST	CRUMMEY TRUST
What are the transfer requirements?	Property vests in the minor at date of transfer.	Income must be distributed to beneficiary. Principal can be retained by the trust.	Trustee must have power to use property and/or income for the benefit of donee until age 21. The donee must receive all accumulated income and principal at age 21. If donee dies before age 21, all accumulated income and principal must pass to the donee's estate as the donee appoints.	Beneficiaries must have power to remove trust assets for a specified period of time. Notice must be given to beneficiaries of any additions to the trust subject to the power. Beneficiary must be given a reasonable time to exercise the power. Donee's lapse of power may create a gift if assets subject to withdrawal exceed the 5 and 5 limitation.
Is the annual exclusion available for gifts to the trust?	Yes, for the entire FMV.	Yes, for the FMV of the income interest.	Yes, generally the FMV.	Yes, for the FMV of property subject to the withdrawal power.
What are the consequences if the donor is also the custodian/ fiduciary?	Included in donor's estate if custodian at time of death.	Included in donor's estate if donor has discretionary power to distribute principal.	Included in donor's estate if donor has discretionary power to distribute income and principal.	Included in donor's estate if donor has discretionary power to distribute income and principal.
What are the income distribution rules?	May accumulate in account or be distributed to or for the benefit of the minor/donee.	Must be distributed to beneficiary.	Trustee must follow trust instrument. May accumulate income in trust or distribute to the beneficiary. If donor is trustee, trust may be treated as grantor trust.	Trustee must follow trust instructions. May accumulate income in trust or distribute to beneficiary.
What are the income tax consequences?	Income is taxed to minor/donee. If under age 24, income is taxed at parents' marginal rates. If income is used to satisfy the donor/grantor's legal obligation to support, that portion of income is taxed to the donor/grantor.	Donee/ beneficiary is taxed on income since it is required to be distributed. If income is used to satisfy the donor/grantor's legal obligation to support, that portion of income is taxed to the donor/grantor.	Taxed at trust level unless distributed. Distributions are taxed to beneficiary. If any portion of the income is used to satisfy the donor/grantor's legal obligation to support, that portion of income is taxed to the donor/ grantor.	Generally, taxed at trust level unless distributed. IRS may consider donee to be the owner of any portion subject to withdrawal power. Distributions are taxed to the beneficiary. If income is used to satisfy the donor/grantor's legal obligation to support, that portion of income is taxed to the donor/grantor.