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Paying for Education Expenses

Education expenses have soared over the past several years. According to collegeboard.com, the 2005–2006 average cost of tuition and fees at a private U.S. college was \$21,235, up 5.9% from the previous year. The rising costs of education have led many to seek ways to help family and friends meet these obligations with minimal adverse tax consequences. A variety of options exist to pay another's education expenses, including direct gifts, tax-advantaged education savings plans and health and education exclusion trusts. But, regardless of which option you choose, careful attention should be paid to potential gift tax and generation-skipping transfer tax (GST tax) issues which may arise.

Additional information on the federal and Connecticut gift tax and GST tax can be found on page 3.

DIRECT GIFTS

Custodial Accounts under the Uniform Transfers to Minors Act. One of the most common ways to help a child save and pay for education expenses is through gifts to a custodial account for the benefit of the child under a Uniform Transfers to Minors Act. Some form of the Uniform Transfers to Minors Act (UTMA) or its predecessor, the Uniform Gifts to Minors Act (UGMA), has been enacted by every state. These Acts provide a mechanism for establishing bank or brokerage accounts that are beneficially owned by a minor, but under the control of a custodian until

the minor attains age 21 (or, in some states, age 18). Transfers to these accounts are treated as completed gifts of *present interests* for gift tax purposes, and so qualify for the \$12,000 gift tax annual exclusion (\$12,000 per year as of 2006).

The custodian, who may be a parent, family member or friend, is expected to manage the account in a fiduciary capacity, but, subject to that standard, can use the assets in the account for the child's education expenses or for other purposes the custodian deems to be in the child's interest. One drawback to the accounts, however, is that the child is given absolute control over the account when he or she attains age 21 (18 in some states). Some children are able to appropriately handle funds at that age, but many are not. Therefore, it may be better to utilize other options if the primary purpose of the account is to assist with the costs of education, particularly if there is a large amount of money involved.

Direct Payment of Tuition. Special gift tax rules exempt payments for qualified medical and education expenses from gift tax. These non-taxable gifts are an excellent way to provide substantial value to donees with minimal tax effect on the donor. To qualify for the exception for education expenses, payment must be made directly to a qualified educational institution and must be for tuition only. The education expense exception does not apply to payments made for room and

continued next page

WIGGIN AND DANA

Counsellors at Law

board or for other ancillary costs of education (e.g., books, supplies, or other similar expenses), nor does it apply to expenses paid by the student to the institution and later reimbursed by the donor. Qualified education organizations include primary, secondary, preparatory and high schools; colleges and universities; and proprietary (privately owned profit-making) secondary institutions. Pre-primary school organizations are not qualified education organizations.

Prepayment of Tuition. A recent development relating to the direct payment of tuition involves prepayment of tuition expenses. The IRS ruled in a private letter ruling that, subject to certain conditions, multiple year prepayments of tuition are not considered taxable gifts for gift or GST tax purposes. These payments differ from direct payments of tuition because the payments are made before the tuition is actually due (possibly years in advance). Permissible tuition expenses are not limited to college tuition payments, but include tuition payments for primary, secondary, preparatory and high schools. The payments must be made directly to the education institution and must be for tuition.

Because of the nature of the IRS ruling, prepaid tuition gifts should be completed carefully and with legal advice regarding the non-taxability of the gift. Factors the IRS will consider when evaluating whether the payments are exempt from gift and GST tax include: (1) whether or not the taxpayers receive any discounts for the prepayment (they should not); (2)

whether the payments are nonrefundable, even if the student stops going to the school (the payments should be non-refundable); (3) whether the payments guarantee enrollment (the payments should not guarantee enrollment); and (4) whether the student or the donor receive special consideration because of the gift (they should not receive special consideration). The prepayment of tuition involves the risk of losing the prepaid money if the child does not attend, transfers, drops out, or is expelled from the school. Because the money belongs to the school upon prepayment, the funds cannot be recovered. In fact, an agreement allowing for the recovery of funds, or even the transfer of funds to another school, may result in the loss of the tax advantages for prepaid tuition.

A prepaid tuition gift is best suited for people concerned that they will not live long enough to pay each year's tuition, who can afford to part with the money permanently, and are comfortable with the notion that the school will keep the money even if the child does not attend the school.

EDUCATION SAVINGS PLANS

Qualified Tuition Programs; Section 529 Plans. Section 529 of the Internal Revenue Code authorizes tax-advantaged accounts to pay for higher education costs, commonly referred to as Qualified Tuition Programs ("QTP") or "529 Plans." Contributions to a QTP are treated as completed gifts of *present interests* for gift tax purposes, and so qualify for the

continued on page 4

A PRIMER ON GIFT TAX AND GENERATION-SKIPPING TRANSFER TAX

GIFT TAX BASICS | Gifts are often utilized to transfer wealth and shift income to the next generation. However, U.S. citizens and other individuals who are residents in the United States are subject to a federal gift tax and, in some cases, a state gift tax. (Connecticut has a gift tax; New York and New Jersey do not.) Donors need to factor in the impact of any applicable gift taxes, but making lifetime gifts can be more tax efficient than making testamentary transfers after death.

THE APPLICABLE CREDIT | Under federal law, each person is allowed a credit that can be applied against either the gift tax on lifetime taxable gifts or the estate tax on transfers made at death. To the extent that you use the credit during your life, there will be a reduction of the amount of the credit that is available to offset any estate tax at your death. As of 2006, the federal credit for gift tax purposes is capped at an amount that would shelter up to \$1,000,000 of gifts from tax. The credit for estate tax purposes can shelter up to \$2,000,000 from estate tax. The applicable credit for gift tax purposes is scheduled to remain at \$1,000,000 through 2009; for estate tax purposes, the credit is scheduled to increase to \$3.5 million in 2009. *Current law provides for substantial changes to the gift tax in 2010 (the year the federal estate tax is scheduled to be repealed), followed by reinstatement in 2011 of the estate and gift tax rules as in effect in 2001. A discussion of those changes is beyond the scope of this Advisory.*

Special Rules for Connecticut taxable gifts. The Connecticut gift tax applies to: (i) gifts by Connecticut residents of intangibles (such as money and securities), and (ii) all gifts of tangible personal property and real estate located in Connecticut. Similar to the federal system, Connecticut gives each donor a gift tax credit for Connecticut gift tax purposes. Currently, Connecticut has a unified gift and estate tax that allows donors to shelter from tax lifetime gifts with a cumulative value of up to \$2,000,000. Thus, one may owe federal gift tax for lifetime gifts over \$1,000,000, but not Connecticut gift tax, until lifetime gifts made after January 1, 2005 surpass \$2,000,000.

THE ANNUAL EXCLUSION | As of 2006 both federal and Connecticut law exempt from gift tax the first \$12,000 of value of a *present interest* gift to any individual. There is no limit on the number of individuals to whom you can give gifts, but only one \$12,000 annual exclusion per year per recipient is allowed.

Gifts of a Present Interest. To qualify for the annual exclusion, gifts must be of a *present interest*, not of a *future interest*. This means that the recipient of the gift must have a current right to use of the money or property that is transferred. Thus, unless the beneficiary has an immediate right of withdrawal, most transfers to a trust will be gifts of *future interests* for the beneficiaries, and, as such, will not qualify for the gift tax annual exclusion.

Gift Splitting. Gift splitting allows a married couple to make non-taxable gifts of up to twice the annual exclusion amount per year

per recipient (currently \$24,000), regardless of which spouse actually made the gift. When couples elect to split gifts, each such gift is treated as made one-half by each spouse.

GENERATION-SKIPPING TRANSFER TAX BASICS | The federal generation-skipping transfer tax (GST tax) was enacted to curb dynastic trusts that might otherwise continue for generations without ever being subject to federal estate tax. The GST tax rate is the same as the top federal estate tax rate (currently 46%; the rate is scheduled to drop to 45% for 2007 through 2009). The GST tax may apply to any gift that passes to a *skip person*, which is defined as a person two or more generations below the donor, or, in non-family situations, a person more than 37-1/2 years younger than the donor. Special generation assignment rules apply where a person who would otherwise be a skip person has a deceased parent. In some instances, such persons are moved up a generation for GST tax purposes, and no GST tax is triggered.

Like the gift tax, outright gifts of up to \$12,000 in value per recipient per year are exempt from the GST tax, as are direct payments of qualified education and medical expenses. However, most gifts in trust, even if the beneficiary has a power of withdrawal, are potentially subject to the GST tax if a trust beneficiary is a *skip person*. As with the federal estate tax, each person has a GST tax exemption that, as of 2006, shelters up to \$2,000,000 of gifts to *skip persons* from the GST tax. The exemption can be used for gifts made during life or at death, and, like the estate tax exemption, is scheduled to increase to \$3,500,000 in 2009. The exemption covers the cumulative total of gifts to *skip persons*, regardless of the number of individual beneficiaries, but as the exemption amount increases, only new gifts can be covered by the additional exemption amount. In other words, if as of 2006 you have generation-skipping transfers totaling \$2,500,000, when the exemption amount increases in 2009 you cannot apply for a refund on the taxes you paid for the gifts made in prior years that were in excess of the exemption amount then in effect. However, as of 2009 you would be able to make an additional \$1,500,000 in generation-skipping transfers without triggering a GST tax liability. (But beware of federal and state gift taxes, as the federal lifetime gift tax exemption is capped at \$1,000,000 and the Connecticut gift tax exemption is capped at \$2,000,000.)

RATES | The federal gift tax rate is the same as the federal estate tax rate, *i.e.*, a progressive tax starting at 18% and rising to 46% (as of 2006). The Connecticut gift tax rate is also progressive, but the maximum rate is 16%. ■

Effective use of intra-family gifts can significantly enhance wealth creation and reduce transfer tax liabilities. Attorneys in Wiggin and Dana's Trusts and Estates Department welcome the opportunity to assist you in implementing a systematic gift program for your family.

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\$12,000 gift tax and GST annual exclusion. Additionally, the regulations allow a contributor to contribute an amount equal to five times the annual exclusion (commonly called “front-loading”) in one year. Currently, this allows a contribution of up to \$60,000 (5 years times \$12,000 annual exclusion) to be placed into a QTP in one year. However, front-loading utilizes the gift tax annual exclusion for that beneficiary for the five-year period. (Therefore, if a donor frontloaded \$60,000, the donor could not utilize the annual exclusion for other gifts to the same beneficiary during the five-year period.)

QTPs provide excellent tax saving opportunities because the gains from the accounts are not subject to income tax upon distribution if used for qualified higher-education expenses. Qualified education expenses include tuition, fees, books, supplies and equipment. Qualified expenses also include room and board expenses within prescribed limitations. One concern about QTPs is that Section 529 is only in effect until 2011. If the legislation is not re-authorized, distributions will be taxed at the intended beneficiary’s tax rate. In addition, other concerns about QTP accounts are that they will affect the beneficiary’s eligibility for financial aid, a penalty tax of 10% is assessed on non-qualified use of the income (in addition to the regular income tax on earnings), only cash can be contributed to the account, each beneficiary must have a separate account, and such accounts cannot be used as collateral for a loan. Advantages of these

accounts include tax-free investing for college expenses, donor control of the investments, use of assets for education expenses beyond tuition, and the option to roll-over investments if a child does not attend college.

Coverdell Education Savings Account (ESA). This type of account enables an individual to set aside up to \$2,000 each year to help pay education expenses for a particular beneficiary (under the age of 18). Earnings accumulate tax-deferred and withdrawals are tax-free and penalty-free when used for qualifying education expenses. One benefit of ESAs is that distributions for elementary and secondary school expenses may qualify as tax-free expenditures.

Contributions to ESAs must be in cash, must be made before the beneficiary reaches 18 years old (unless the beneficiary is a special needs beneficiary), and cannot be combined with other property. The total contribution for a beneficiary cannot exceed \$2,000 per year. Contributions to a single beneficiary over \$2,000, even if from multiple donors, will subject the beneficiary to an excise tax. The contribution limit is reduced for donors whose adjusted gross income is between \$95,000–\$110,000 (\$190,000–\$220,000 if filing a joint return). Individuals with adjusted gross income over \$110,000 (\$220,000 if filing a joint return) cannot make contributions to ESAs. Therefore, a donor (who meets the income guidelines) can contribute \$2,000 to any number of beneficiaries. However, each beneficiary cannot receive further

ESA contributions from anyone else in that year without having to pay an excise tax on the excess contributions. Thus, although ESAs offer a tax-efficient education savings option, it may be hard to accumulate a large sum of money in such accounts.

If an ESA beneficiary has not used the funds by age 30, any balance must be distributed and the income will be taxed at that time. Alternatively, the remaining funds can be rolled-over to another ESA for an eligible family member under age 30 for use toward his or her education expenses.

TRUSTS

Trusts can be individually designed to address virtually any situation, but it is not uncommon to establish a trust as a vehicle to save for a child's education. Section 2503(c) trusts and Health and Education Exclusion Trusts are two types of trusts that allow donors to effectively save for a beneficiary's education.

Code §2503(c) Trusts. Internal Revenue Code Section 2503(c) authorizes the creation of trusts for minors designed to capture the annual exclusion amount. A gift to a §2503(c) trust is treated as a gift of a *present interest*, and so transfers of up to \$12,000 per year (or \$24,000 per year, if made by a married couple splitting gifts) can be made to the trust with no gift tax consequences. Section 2503(c) requires that (1) the trust principal and income be available for distribution for the benefit of the minor beneficiary, (2) the distribution of all trust principal and income to the

beneficiary when he or she attains 21, and (3) if the beneficiary dies before he or she reaches 21, all trust principal and income must be paid to the beneficiary's estate or his or her appointee under a general power of appointment.

Like gifts under the UTMA, a §2503(c) trust must permit the child to have full control of the trust property when he or she attains age 21. One reason for using such a trust, rather than a UTMA account, is that there are no restrictions on the property that can be transferred to the trust or the investments the trustee can make (subject to general fiduciary principles). Thus, a §2503(c) trust may have professional trustee management of the account and may hold unusual assets. Another reason to select a §2503(c) trust is the possibility of extending the trust for a period of time after the beneficiary attains age 21, provided the beneficiary is given a withdrawal power at age 21. For example, a donor could create a §2503(c) trust which allows the beneficiary an unfettered right to withdraw trust assets for a relatively short time period of time (*e.g.*, 30 days) after the beneficiary attains age 21. To the extent the beneficiary does not exercise the withdrawal right, the assets remain in trust until some later date specified in the trust instrument (*e.g.*, age 30). This hybrid form of trust is sometimes called a "window trust."

Health and Education Exclusion Trusts. A Health and Education Exclusion Trust (commonly referred to as a HEET) is a special kind of multigenerational (or

continued next page

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“dynastic”) trust that can be used to pay certain tuition expenses and unreimbursed medical expenses. The trust beneficiaries may include children, grandchildren and other family members, but must also include at least one charitable beneficiary who receives at least 10% of the trust’s income each year. In addition, trust distributions for tuition or medical expenses cannot be paid to an individual beneficiary, but must be paid directly to the educational institution or medical provider. HEETs must be irrevocable. These trusts may be drafted so that contributions to the trusts are treated as completed gifts of *present interests* for gift tax purposes, and, therefore, will qualify for the \$12,000 gift tax annual exclusion.

Advantages of this type of trust include that the funds cannot be used for anything other than direct payments for a beneficiary’s health and education and that the trust can benefit several generations, free of future gift, estate and GST taxes. Trust distributions may be allocated for the benefit of grandchildren and even more remote descendants as future needs arise. Any type of asset can be contributed to the trust. Funds held in the trust can be invested in any asset deemed prudent to the trustee, but distributions must be made in cash and directly to the educational institution or medical provider. Income will be taxable to the trust or to the beneficiaries for whose benefit distributions are made. ■

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