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Practical Strategies for Funding a Child's College Education

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There are a variety of techniques for funding a child's education, including different types of trusts, UTMA custodianships, Section 529 college savings plans, and the Section 2503(e) gift tax exclusion for the direct payment of tuition.

A parent or grandparent faced with having to fund a child's or grandchild's college education must consider carefully the various financial and tax-advantaged tools that are available. The skyrocketing costs of college and post-graduate tuition (as well as related expenses like room and board) can be daunting. The selection of an appropriate gifting or college savings strategy, however, can provide piece of mind that the funds will be available when needed, and can reduce the effective tax-adjusted cost of the child's higher education. Many parents or grandparents, though, are unaware of the full gamut of techniques that may be available to them and often overlook the possibility of integrating these strategies into their overall financial and estate plan.

Section 529 college savings plans have emerged as a popular tool for accumulating funds for a child's or grandchild's college education on a tax-advantaged basis. But whether the use of a Section 529 plan (or a particular state's Section 529 plan) is the optimal college savings technique under the circumstances will depend on a number of factors. Although, generally, Section 529 plans can be a wonderful college savings device with their tax-advantaged features, in certain instances a parent or grandparent of considerable wealth may be better advised to make only limited use of Section 529 plans and instead plan on paying the child's college tuition directly to the school because such payments are entirely income and gift tax-free.[1] The parent's or grandparent's annual exclusion gifts could then be devoted to other purposes—such as funding an irrevocable trust, with "Crummey powers of withdrawal," with property that may be expected to appreciate substantially in value.

This article provides a practical discussion of methods to fund a child's or grandchild's college education. The principal focus here is on contrasting and integrating the use of Section 529 college savings plans with gifting programs that devote annual exclusion gifts to other purposes while contemplating that college tuition will be paid directly by the parent or grandparent to take advantage of the gift tax exclusion for the direct payment of tuition under Section 2503(e).[2] The appropriate road to take will ultimately depend on the parent's or grandparent's overall circumstances, and an integrated approach— that seeks to take maximum advantage of the state income tax deduction for contributions to a Section 529 plan to fill in the interstices not covered by the gift tax tuition exclusion (such as the costs of room and board, books, and supplies)—may present the best of all worlds.

Basics of gifts to minors

Gift tax rules. Each US citizen or resident has a lifetime exemption from federal gift tax of $1 million.[3] Thus, the first $1 million of taxable gifts by a US citizen or resident[4] will not generate gift tax. As a result of the partial "decoupling" of the estate and gift tax systems brought about by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the gift tax applicable exclusion amount has been separated from the applicable exclusion amount for federal estate tax purposes (as well as for federal generation-skipping transfer ("GST") tax purposes).

While both the federal estate tax and the GST tax applicable exclusion amounts are $2 million for persons dying, or making generation-skipping transfers, in 2006,[5] the gift tax applicable exclusion amount is $1 million and will remain frozen at that level in subsequent years.[6] Moreover, in 2010, when the federal estate tax and the GST tax are scheduled to be repealed under present law, the gift tax will remain with the same $1 million lifetime exemption (although with the maximum gift tax rate reduced to 35%, as compared to the current top federal gift tax rate of 46% for taxable gifts made during 2006).[7]

Not every gift will consume part of the donor's lifetime $1 million exemption. There are three main categories of gifts that are excluded from the gift tax base and therefore do not generate any gift tax: (1) the exclusion for amounts paid for the donee's medical care,[8] (2) the exclusion for tuition paid to a qualified educational organization[9] (discussed more later), and (3) the $12,000 per donee annual exclusion for gifts of present interests in property[10] (discussed immediately below).

The $12,000 per donee annual exclusion for gifts of present interests in property can be doubled to $24,000 per donee if the donor's spouse consents to "split" all gifts to third-party donees made during the year by making an election to such effect on the donor's federal gift tax return for that year.[11] If gift-splitting is elected, all gifts to third parties made during the taxable year are treated as made one-half by each spouse.[12] Liability for the entire amount of tax on split gifts made during a calendar year is joint and several.[13]

Not every gift is eligible for the gift tax annual exclusion. To qualify for the annual exclusion, the interest transferred must be a present interest in property; in contrast, future interests are not entitled to the annual exclusion.[14] Reg. 25.2503- 3(b) defines a present interest as "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)." In contrast, if an interest in property will not commence in use, possession, or enjoyment until some future date or time, such interest is a future interest, the gift of which will not qualify for the annual exclusion.[15]

Gifts in trust for minors. Aside from Section 529 plans, there are three types of gifts in trust qualifying for the gift tax annual exclusion that are frequently used to fund a child's or grandchild's college education: (1) Section 2503(b) trusts, (2) Section 2503(c) trusts for minors, and (3) "Crummey" power of withdrawal trusts.

Section 2503(b) trusts. A gift of an income interest in a trust that meets the requirements of Section 2503(b) will qualify for the annual exclusion. Gifts in trust generally create two separate interests: an interest in trust income (the "income interest") and an interest in the principal of the trust upon its termination (the "remainder interest"). The remainder interest is a future interest to which the annual exclusion may not be applied.[16] The annual exclusion may, however, be applied to a gift of an income interest if the trust instrument gives the beneficiary the unrestricted current right to an amount of the trust income that is ascertainable.[17] In other words, to obtain the annual exclusion for an income interest in trust under Section 2503(b), it must be a "pay all income to a single beneficiary" type of arrangement, with no other person being a potential beneficiary of income or principal from that trust share during the taxable year in question.

Section 2503(c) trusts for minors. The second way to qualify a gift of an interest in trust for the annual exclusion is to have the trust instrument meet the requirements of Section 2503(c). This section allows gifts to an individual under age 21 to qualify for the annual exclusion as a gift of a present interest in property if the following three requirements are met: (1) the income and principal may be spent by, or for the benefit of, the donee before his or her attaining age 21;[18] (2) to the extent that the property is not so spent, the property will be payable to the donee upon attaining age 21;[19] and (3) in the event that the donee dies before reaching age 21, the trust property must be payable either to the estate of the donee or as he or she may appoint under a general power of appointment. If these requirements are met, the entire value of the trust qualifies for the annual exclusion.[20]

'Crummey' power of withdrawal trusts. The third way to obtain the annual exclusion through a gift in trust is by including so-called Crummey powers of withdrawal in the trust instrument. A Crummey power—which is named after a Ninth Circuit case from 1968[21]—is a right of withdrawal that allows a beneficiary to demand the immediate payment of some amount gifted to a trust to enable the gift to qualify for the annual exclusion. A trust with Crummey provisions, if properly drafted and administered, has many advantages over Section 2503(b) and Section 2503(c) trusts. Unlike a Section 2503(b) trust, a Crummey trust need not pay out all its income to qualify for the annual exclusion. Moreover, unlike a Section 2503(c) trust, a Crummey trust need not be subject to termination when the income beneficiary reaches age 21. Further, a Crummey trust allows a donor to apply multiple annual exclusion amounts with respect to gifts to multiple beneficiaries to reduce or eliminate taxable gifts.[22]

Most irrevocable life insurance trusts will be drafted to include Crummey powers of withdrawal. Thus, depending on the circumstances, an irrevocable life insurance trust may use up some, if not all, of the gift tax annual exclusion allocable to a child or grandchild. This could have the effect of causing a contribution to a Section 529 plan account to be a taxable gift to the extent that it exceeds the $12,000 per donee ($24,000 with gift-splitting) annual exclusion limit.

UTMA custodianships. A custodianship under the Uniform Transfers to Minors Act ("UTMA"), or the Uniform Gifts to Minors Act ("UGMA"), provides a possible alternative to trusts (and to Section 529 plans) as a vehicle for gifts to minors.[23] A custodianship is a statutory creation that generally allows an adult to hold property on behalf of a minor under age 21 without any need for court appointment.[24] Transfers can generally be made to a custodian on behalf of a minor unless the governing instrument prohibits it.[25]

In general, if the beneficiary dies before age 21 (or age 18 if such was elected for the account), the UTMA account will be payable to the beneficiary's estate.[26]

The custodianship relationship will generally terminate when the minor reaches age 21, at which point the custodian is required to transfer the custodian property to the minor.[27] Accordingly, if the donor wants the property to be managed without distribution to the minor after the minor reaches age 21, a custodianship may not be appropriate. In that case, a trust (or a Section 529 plan) perhaps should be considered instead.

Section 529 plans

Against the backdrop of the federal gift tax rules and the various trusts for minors and custodianship arrangements discussed above, the question arises how a person who wants to put aside funds for a child's or grandchild's education in a tax-efficient manner should go about it. One very helpful tool that has come to prominence over the last few years is the Section 529 college savings plan.

There are two broad types of Section 529 college savings plans. The first are the prepaid tuition plans, under which individuals may prepay tuition by purchasing tuition credits or certificates on behalf of a designated beneficiary at certain colleges and universities.[28] The second type of Section 529 plans are the college savings plans, under which persons may make contributions to an account that is established to meet the higher educational expenses of the designated beneficiary of the account.[29] The college savings plans are separately administered by all 50 states and the District of Columbia, which in turn outsource various administrative responsibilities to financial institutions.[30] This second type of Section 529 plan (which is by far the more popular) is commonly referred to as a "Section 529 plan" and will be the focus of the following discussion.

A Section 529 plan allows funds to accumulate for a beneficiary's higher education needs income tax-free, while allowing the donor, who is referred to as the "account owner," a tremendous amount of flexibility. If the funds are used for the designated beneficiary's "qualified higher education expenses," the withdrawals are tax-free for federal income tax purposes,[31] and generally for state income tax purposes as well.

The definition of "qualified higher education expenses" is broader than just tuition, and depending on a particular state's plan, generally will also permit withdrawals to be applied to the payment of room and board, fees, books and supplies, plus expenses for special needs services that are incurred in connection with the enrollment or attendance of a special needs beneficiary.[32]

The full value of a Section 529 plan can be used at any accredited college or university in the country—not just in the Section 529 plan's home state. The plan's funds can also be used at some foreign educational institutions.

Typically, a parent or grandparent creates a Section 529 plan account for the benefit of a child or grandchild.[33] Significantly, unlike certain other federal tax-advantaged vehicles (such as the Coverdell Education Savings Account[34]), there are no income limits on a contributor to a Section 529 plan account. Any person (including trusts, organizations, and custodians under UTMA) may establish a Section 529 plan on behalf of any individual beneficiary.[35] There are no relationship requirements between the owner and the beneficiary (*e.g.*, the beneficiary does not have to be a dependent of the account owner), and there are no income limitations on who can be a beneficiary. There can be only one beneficiary per plan, but there can be more than one plan per beneficiary. An account owner can even create a Section 529 plan for himself or herself.

One of the most appealing aspects of the plan is that the person making the contribution, and not the beneficiary, is the account owner and has control over the distribution of assets.[36] The account owner can even cause the funds in the account to be returned to the account owner, although in that case the amount of the withdrawal that is attributable to the untaxed earnings of the account would be subject to a 10% penalty tax and includable in the account owner's gross income as the recipient of the previously untaxed earnings.[37]

The maximum amount that can be contributed to a Section 529 plan varies from state to state. As of May 2006, the maximum in New York is $235,000 and the maximum in New Jersey is $305,000. This is a ceiling on the aggregate contributions for each beneficiary, no matter how many plans are in existence for that beneficiary. If the assets in the plan grow beyond the ceiling, they can stay in the plan, but once the ceiling has been reached, no additional contributions may be made to a Section 529 plan for that beneficiary.[38]

A contribution to a Section 529 plan for the benefit of another person is a completed gift for federal gift tax purposes and is treated as a gift of a present interest in property that qualifies for the gift tax annual exclusion.[39] It does not, however, qualify for the tuition exclusion from gift tax.[40] In addition, subject to one important exception discussed below, funds contributed to a Section 529 plan account are not includable in the account owner's estate for federal estate tax purposes even though the account owner has the ability to have the funds returned to him.[41]

A contribution to a Section 529 plan account is not deductible for federal income tax purposes, but it may be deductible for state income tax purposes. For example, a New York state resident can deduct up to $5,000 (and $10,000, if married persons file jointly) on his or her New York state income tax return for contributions to the New York sponsored Section 529 plan. The state income tax deduction also extends to non-residents who work in New York and file returns in New York. The undistributed earnings of the New York state plan are exempt from New York income tax.[42]

Only cash can be used to fund a contribution to a Section 529 plan account.[43] Section 529 plan accounts are not self-directed;[44] rather, the account owner has to choose from a panoply of broad investment categories—generally, various allocations of stocks and bonds which may be changed annually. There can be only one designated beneficiary of each account and a separate accounting must be kept for each account.[45] Plan assets may not be used as security for loans.[46] In addition, the plan is required to prohibit contributions in excess of the amount necessary to qualify for higher education expenses of the beneficiary.[47]

If the account assets are not needed for qualified higher education expenses for the designated beneficiary, the account owner may change the beneficiary of the account to a new beneficiary or roll over the account to another Section 529 plan account for a new beneficiary.[48] As further discussed below, this may potentially result in treatment as a taxable gift *by the original beneficiary* to the new beneficiary if the new beneficiary is deemed to belong to a generation level that is lower than that assigned to the original beneficiary.[49] This, however, will not result in the imposition of federal *income* taxes *on the new beneficiary* (1) if the new beneficiary is a "family member" of the original beneficiary and (2) if a rollover distribution is involved, the rollover occurs within 60 days of the withdrawal.[50] For this purpose, family members include siblings, parents, children, grandchildren, nieces, nephews, aunts and uncles, and the spouses of any such individuals.[51]

The New York Section 529 plan allows the account owner to change investment strategy within an account once a year. In addition, the account owner can roll over the account to another plan, with a limit of one rollover distribution per beneficiary within a 12-month period. The rollover to another state's Section 529 plan will, however, constitute a taxable distribution for New York state income tax purposes with respect to the previously untaxed earnings. It will also trigger a recapture of income tax deductions taken on prior New York state income tax returns.[52]

There is a special exception that allows the donor to contribute more than one annual exclusion amount (presently $12,000 for gifts during 2006) on behalf of a donee in a single calendar year without being subject to gift tax. A person can transfer up to $60,000 (or up to $120,000 if splitting gifts with his or her spouse) in one year to one account and prorate the contribution over a five-year period by making an election on a federal gift tax return. The donor is treated as having made five annual gifts of the exclusion amounts.[53] If the donor dies before the end of this five-year period, a prorated amount of the excess contribution will be included in the account owner's gross estate for federal estate tax purposes.[54]

The donor can remain the account owner and withdraw funds for non-qualified purposes (that is, expenses that do not pertain to the beneficiary's tuition, campus room and board, fees, books and supplies, and certain other expenses).[55] If the account owner exercises the withdrawal right, he or she is subject to federal (and possibly also state) income tax on the portion of the withdrawal that represents earnings of the account[56] as well as a 10% penalty on that portion.[57] Upon the death of the beneficiary, or if the beneficiary becomes disabled and unable to pursue higher education, or if the beneficiary is the recipient of a qualified scholarship, the account owner can close the account and the account balance can be received without any penalty (although the previously untaxed earnings of the account would then be included in the account owner's gross income as ordinary income, or alternatively, as income to the beneficiary's estate).[58]

In addition, if the new beneficiary is a generation below that of the prior beneficiary (as defined by reference to the rules governing generation assignment for GST tax purposes), a gift is deemed to have been made *by the prior beneficiary* to the new beneficiary.[59] According to the Proposed Regulations, this result of a gift by the prior beneficiary will occur "regardless of whether the new beneficiary is a member of the family of the old beneficiary."[60] GST tax consequences can occur if the new beneficiary is deemed to belong to a generation that is two or more generations below the original beneficiary's generation. The five-year averaging rule is likewise available for these gifts.[61]

To summarize a few of the rules discussed above, a transfer from an existing Section 529 plan account to a Section 529 plan account for a new beneficiary who is not a family member of the original beneficiary is not a rollover and is treated as a distribution *to the recipient for federal income tax purposes.*[62] Moreover, the distribution would be treated as a gift *by the original beneficiary for federal gift tax purposes* if the new beneficiary is at least one generation below that of the original beneficiary.[63] Further, the distribution would be subject to GST tax if the new beneficiary were deemed to belong to a generation that is two or more generations below the original beneficiary.[64]

It is a good idea to designate a successor account owner, and most plan applications provide for this. While the Section 529 plan account is generally not includable in the account owner's gross estate for federal estate tax purposes, it may become part of the account owner's probate estate if no successor is designated for the account. Without a designated successor, the account could pass to a residuary estate beneficiary as a successor-in-interest who could then liquidate the account— much to the chagrin of the designated beneficiary under the Section 529 plan.[65]

Finally, one should also be mindful that the designation of a beneficiary under a Section 529 plan could potentially have an adverse effect upon the beneficiary's eligibility to receive financial aid.[66]

Gift tax exclusion for direct payment of tuition

Section 2503(e) contains an exclusion from gift tax for the direct payment of tuition on behalf of an individual to a qualified educational organization for education or training. To qualify for the tuition exclusion, the educational organization must be one that normally maintains a regular faculty and curriculum, and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.[67]

The educational organization must also have as its primary purpose the presentation of formal instruction.[68] If an organization is engaged in both educational and non-educational activities, the tuition exclusion is not available unless the noneducational activities are merely "incidental" to the formal educational instruction.[69] The term "educational organization" includes primary, secondary, preparatory and high schools, and colleges and universities.[70]

It includes pre-schools and day care programs only to the extent that they meet these requirements.[71]

To qualify under Section 2503(e), the tuition must be paid directly to the school, and it may not be reimbursed to the student.[72] There is no requirement that the donor and donee be related for this exclusion to apply.[73]

Tuition for future years may be prepaid by a donor, and qualify for this exclusion, provided that tuition must be forfeited and cannot be subject to refund in the event the donee ceases to attend the school.[74]

Significantly, the tuition exclusion applies only to *tuition* for full-time or part-time studies.[75] It does *not* cover amounts paid for books, supplies, room and board, or any other incidental expenses that do not constitute tuition.[76] Hence, this is a gap that Section 529 plans can be used to fill even if use of the tuition exclusion is contemplated.

Contributions to Section 529 plans do not qualify for the tuition exclusion.[77] This therefore raises the question (assuming that the donor is in good health and expects to be alive when the child or grandchild reaches college age) whether it may be advisable for the donor to devote his gift tax annual exclusion dollars to some other vehicle since the direct payment of tuition is gift (and GST) tax-free.

An integrated approach to college savings

In light of the foregoing tax rules and the variety of vehicles that may be available to accumulate funds for a child's or grandchild's college education, the following considerations should be evaluated by a person (or his or her advisor) in determining whether, and to what extent, Section 529 plans should be used as a college savings technique:

A. Does the parent or grandparent presently have a gifting program in place that (1) contemplates the direct payment of tuition qualifying for the Section 2503(e) tuition exclusion and (2) stands to make better use of the gift tax annual exclusion, such as by gifting property that is expected to appreciate substantially in value to an irrevocable trust established for the child's or grandchild's benefit? The existing gifting program could also include gifts made to an irrevocable life insurance trust with Crummey powers of withdrawal as to which the child is a beneficiary. Depending on items B, C and D below, if the answer to this question is "yes," this could potentially militate, from a tax-efficiency standpoint, in favor of limiting gifts to a Section 529 plan perhaps to the maximum annual amount that can qualify for a state income tax deduction. In New York, this would be an aggregate annual amount of $5,000 (or $10,000 for a married couple filing jointly) for all Section 529 plan beneficiaries.

B. Is there a material risk that the parent or grandparent may fail to survive to when the child or grandchild reaches college age? If the answer is "yes," this could weigh in favor of making Section 529 plan contributions in excess of the maximum state deductible amounts.

C. Is there a material risk that the parent or grandparent may become incapacitated and rendered unable to pay the college tuition? If the answer is "yes," this could weigh in favor of making Section 529 plan contributions in excess of the maximum state deductible amounts. This risk, however, can alleviated by having a properly drafted revocable trust or durable power of attorney that authorizes such gifts.

D. Does the particular state's Section 529 plan permit the donor to obtain a state income tax deduction for contributions to that plan, and what are the applicable limits on the state income tax deduction? The answer to this question may make it desirable to limit contributions to the home-state plan. For example, a New York state resident can deduct up to $5,000 (and $10,000, if married persons file jointly) on his or her New York state income tax return for aggregate annual contributions to the New York-sponsored Section 529 plan. The New York state income tax deduction also extends to non-residents who work in New York and file returns in New York.

E. What is the investment performance of the particular state's Section 529 plan?

F. What investment options (and opportunities to change investment options) are permitted by the particular state's Section 529 plan?

G. What are the annual fees imposed by the particular state's Section 529 plan? In general, the annual fees will usually be less if the account owner invests directly in the Section 529 plan, as opposed to investing through a financial intermediary, such as agents affiliated with the plan sponsor.

H. What amount of creditor protection, if any, is available to the account owner with respect to contributions to that state's Section 529 plan? For instance, under New York law, the New York Section 529 plan assets are exempt from money judgments against the account owner as follows: (1) plan assets are fully exempt if the account is established in connection with certain scholarship programs; (2) plan assets are fully exempt if "the judgment debtor is the account owner and designated beneficiary of such account and is a minor;" and (3) otherwise, up to $10,000 of the plan assets is exempt if the judgment debtor is the account owner.[78]

I. What are the state income tax rules that apply to distributions from the particular state's Section 529 plan? Preferential state income tax treatment will usually be available for account owners who participate in Section 529 plans sponsored by their home state.

J. What restrictions are imposed upon changing a beneficiary of the particular state's Section 529 plan? Are the limitations more restrictive than what is permitted under federal law?

K. What is the maximum amount that can be contributed to the particular state's plan on behalf of a beneficiary?

L. What control does the account owner have? Who can be a successor account owner and what rights does that person have?

M. Are there any restrictions imposed by the plan on the form that payments from the plan must take?

N. Are there any age limits for beneficiaries under the particular state's plan?

O. What is the reputation of the plan's investment manager?

There is no one-size-fits-all solution when deciding to what extent a Section 529 plan should be used to fund a child's or grandchild's college and postgraduate education. In general, the following factors make a Section 529 plan a highly desirable vehicle for college savings: (1) the flexibility of Section 529 plans in allowing withdrawals and the change of beneficiaries, (2) the advantage of tax-free treatment for the accumulation of income and qualified distributions, and (3) the state income tax deduction that may be available for contributions to the home-state Section 529 plan. Even if the parent or grandparent has other purposes in mind for annual exclusion gifts (including gifts to irrevocable life insurance trusts with *Crummey* powers of withdrawal) and wishes to take advantage of the gift tax exclusion under Section 2503(e) for the direct payment of college tuition, Section 529 plans can still serve as a helpful complementary college savings device to meet the costs of room and board, books, supplies, and fees that the gift tax tuition exclusion does not cover. Finally, Section 529 plans provide some measure of assurance that funds will be available to meet the costs of college education should the parent or grandparent die unexpectedly, or become incapacitated without having a properly drawn revocable trust or durable power of attorney in place. Thus, in many instances, it will be desirable to consider making Section 529 plan contributions to one's home-state plan, at least to the extent of the maximum amount that is deductible annually for state income tax purposes.

Practice Notes

In certain instances, a parent or grandparent of considerable wealth may be better advised to make only limited use of Section 529 plans and instead plan on paying the child's college tuition directly to the school because such payments are entirely income and gift tax-free.

Endnotes

1 Sections 102 and 2503(e).

2 There are other smaller-scale techniques which may be used to complement these primary alternatives and which are subject to limitations based on the donor's adjusted gross income—for example, contributions to a Coverdell Education Savings Account (see Section 530). In addition, for qualified education expenses paid during the year for a qualified student, the donor may potentially be able to claim (1) the Hope Credit (see Section 25A) and (2) the Lifetime Learning Credit (see Section 25A). See also IRS Publication 970, "Tax Benefits for Education" (for 2005 tax returns).

3 Section 2505(a). The following states also impose a gift tax: Connecticut, Louisiana, and North Carolina.

4 In this article, the term resident denotes a US domiciliary who is not a US citizen. Special gift tax rules apply to gifts by noncitizens who are not US residents (i.e., non-resident aliens).

5 *See* Sections 2010(c) and 2631(c).

6 Section 2505(a).

7 Sections 2502(a) and 2001(c). Because of the possibility of federal estate tax repeal, most advisors believe that (except perhaps in the case of "deathbed gifts," which can be used to save state estate taxes) one should not pay gift taxes by making lifetime taxable gifts in excess of the $1 million applicable exclusion amount for gift taxes. (This amount is effectively doubled to $2 million if a husband and wife "gift-split" on all lifetime taxable gifts.) This is so even though it is generally more tax-efficient to make gifts subject to gift tax than to make bequests subject to the estate tax, because of the tax-exclusive nature of the gift tax which, unlike the estate tax, excludes from the tax base the amount of tax paid on the gift. The prevailing school of thought tends to be: "Why pay any gift tax at all if, when you die, there may not be any estate tax, or if there is an estate tax, the exemption amount may be

substantially increased and the estate tax rates substantially reduced?" As a result of this sentiment, the rule of thumb is generally that a donor should at all times be mindful of the $1 million limit on lifetime taxable gifts so as to avoid triggering any gift tax, and to place a premium on exclusions and techniques that will prevent the $1 million lifetime gift tax exemption from being exceeded.

8 Section 2503(e).

9 *Id*.

10 Section 2503(b).

11 Section 2513(a). To be eligible to gift-split, both the donor and the donor's spouse must be US citizens or residents. Non-resident aliens are ineligible to split gifts with their spouses.

12 Section 2513(a)(1).

13 Section 2513(d).

14 *See* Section 2503(b).

15 Reg. 25.2503-3(a).

16 *Id*.

17 *See* Reg. 25.2503-3(c), Example 3. The income interest in trust will not be ascertainable and therefore will not qualify for the annual exclusion if any of the following were to occur: (1) the trustee were authorized to accumulate the income and add it back to principal; (2) the trustee were authorized to pay income not only to the donee in question, but to some other person, in other than fixed shares; or (3) if principal could be invaded for the benefit of a person other than the donee in question. See Reg. 25.2503-3(c), Examples 1, 3, and 4.

18 To meet the requirement that the trust benefit the minor, there must not be any substantial restrictions on the trustee's discretion to spend income or principal for the benefit of the minor prior to the minor's attaining age 21. Although it is not necessary that the trust instrument direct that all income be paid over currently to or for the benefit of the donee, the trust instrument must give the trustee discretion to pay over income to or for the benefit of the donee, and may not contain substantial restrictions on the trustee's exercise of that discretion. *See* Reg. 25.2503-4(b); Bederka and Butler, "Inter Vivos Gifts," at G-8, reprinted in 2 *Practical Skills: An Introduction to Estate Planning* (New York State Bar Ass'n 2005) (hereinafter "Bederka and Butler").

19 There is, however, some flexibility permitted here. For example, the trust instrument may provide that the trust may continue beyond the beneficiary's reaching age 21, provided that the beneficiary is given the right, upon attaining age 21, either (1) to demand distribution of the trust fund at any time, or (2) to compel distribution during a limited period of time by notice to the trustee. See Reg. 25.2503-4(b). In Ltr. Rul. 8512048, the IRS determined that giving the beneficiary 60 days after reaching his 21st birthday to exercise his power to terminate the trust and compel the immediate distribution of all or any portion of the principal and accrued income of the trust was sufficient to qualify the trust for the gift tax annual exclusion. If the beneficiary does not exercise his or her right to terminate the trust, the trust will continue for the term provided in the trust instrument. *See* Bederka and Butler, supra note 18, at G-9. (Pursuant to Section 6110(k)(3), a private letter ruling may not be relied upon by anyone other than the taxpayer who requested the ruling.)

20 *See* Section 2503(c). To avoid adverse estate tax consequences to the donor, the donor should not serve as sole trustee of a Section 2503(c) trust. Otherwise, the trust property will be included in the donor's gross estate under Sections 2036(a)(2) and 2038 as a retained power to control beneficial enjoyment.

21 Crummey, 22 AFTR 2d 6023, 397 F2d 82, 68-2 USTC ¶12541 (CA-9, 1968).

22 Typically, a Crummey trust gives the beneficiaries the right to demand, annually, trust principal up to the amount of the gift tax annual exclusion, usually not exceeding the amount of the current year transfer that has been allocated to each beneficiary. Beneficiaries are usually given a limited time to exercise this right of withdrawal, and it is good practice to give the beneficiaries written notice of this right. This right of withdrawal, regardless of whether it is exercised, converts what would otherwise be a gift of a future interest in trust into a gift of a present interest that qualifies for the annual exclusion. A well-drafted Crummey trust should also contain provisions to neutralize as much as possible the estate and gift tax attributes of powers of withdrawal (which are general powers of appointment) to avoid adverse estate and gift tax consequences to the beneficiaries. Additional provisions may be included in the trust instrument that cause the trust to be a "grantor trust" as to the grantor for federal income tax purposes, including with respect to the portion of

the trust that is attributable to the beneficiary's power of withdrawal to the extent that such withdrawal would be charged against the income account. *See* Sections 671, 678(a), and 678(b).

23 This discussion will solely address UTMA, as opposed to UGMA (which has been repealed and superseded by UTMA in most jurisdictions). In addition, the discussion will focus on the New York version of UTMA, as set forth in section 7-6.1 et seq. of the Estates, Powers and Trusts Law of the State of New York (the "NY EPTL").

24 *See* NY EPTL §7-6.20.

25 *See*, e.g., NY EPTL §7-6.6(c). Under the New York UTMA, the custodianship relationship generally continues until the minor reaches age 21, unless an election is made to reduce the termination age to 18. See *id*. §7-6.21. The type of property that can be held by a custodian includes every type of property and is not limited to that specifically enumerated in the statute. *See id*. §7- 6.9. In addition, the circumstances under which an UTMA account can be established are very broad. For example, UTMA allows a fiduciary to transfer property to a custodian in the absence of a will, or where there is a will, but the will contains no authorization therefor. *See id*. §7-6.6(a). It also permits a debtor of a minor to pay funds to a custodian. *See id.* §7-6.7. The custodian is allowed to use custodian property as he or she considers advisable for the use of the minor. See *id*. §7-6.14. The custodian need not consider the resources of the minor or any duty or ability of anyone (including the custodian) to support the minor. *See id*. §7-6.14(a). The form of written instrument to establish a custodianship is set forth in the statute at NY EPTL §7-6.9(b). Basically, the instrument needs to say that the transfer is to a person as custodian for the minor under the New York Uniform Transfers to Minors Act. Only one custodian may act, since the New York UTMA does not provide for co-custodians. See *id*. §7-6.10. Moreover, an UTMA account can have only one beneficiary. *See id*. UTMA has been enacted by most jurisdictions, so the account is unlikely to be affected if the custodian or minor relocates to another state. *See* Porter and Gaynor, "Lifetime Gifts and Trusts for Minors," at H-21, reprinted in 2 *Practical Skills: An Introduction to Estate Planning* (New York State Bar Ass'n 2005) (hereinafter "Porter and Gaynor").

26 *See* NY EPTL §§7-6.20, 7-6.21. Depending on the circumstances, the donor should generally not be the custodian for the minor. Otherwise, if the donor dies while acting as custodian, the custodian property will be included in the donor's estate for federal estate tax purposes under IRC Section 2036(a)(2).

27 *See* NY EPTL §7-6.20.

28 Section 529(b)(1)(A)(i).

29 Section 529(b)(1)(A)(ii).

30 *See* Porter and Gaynor, supra note 25, at H-8.

31 *See* Section 529(c)(3)(B).

32 Section 529(e)(3); Prop. Reg. 1.529-1(c).

33 Alternatively, a grandparent could make a gift to a child who, in turn, could use the gift to establish a Section 529 plan account for the grandparent's grandchild.

34 *See* Section 530.

35 If the account owner is a custodian under UTMA, the creation of the Section 529 plan account is subject to the limits of the custodianship. *See* Ringel, "Paying for College with Section 529 College Savings Plans," at 377, reprinted in 35th *Annual Estate Planning Institute* (Practicing Law Institute 2004) (hereinafter "Ringel").

36 *See* Prop. Reg. 1.529-1(c); Porter and Gaynor, supra note 25, at H-7.

37 *See* Sections 529(c)(3)(A) and 529(c)(6).

38 Each state's plan (consistent with plan qualification under IRC Section 529) presumably would be self-policing to ensure that contributions in excess of the ceiling would not be allowed. Information and links to the various state Section 529 plans can be obtained through the websites www.savingforcollege.com and www.collegesavings.org.

39 *See* Section 529(c)(2)(A)(i); Prop. Reg. 1.529-5(b). A contribution to a Section 529 plan account also qualifies for the annual exclusion for GST tax purposes under IRC Section 2642(c)(2). See Prop. Reg. 1.529-5(b)(1).

40 Section 529(c)(2)(A)(ii); Prop. Reg. 1.529-5(b).

41 Section 529(c)(4)(A).

42 *See* Ringel, *supra* note 35, at 384-85; see also New York's 529 College Savings Program Direct Plan, Program Brochure and Tuition Savings Agreement, at 20 (hereinafter "New York 529 Program Brochure").

43 Section 529(b)(2).

44 Section 529(b)(4).

45 Section 529(b)(3).

46 Section 529(b)(5).

47 Section 529(b)(6). All contributions for one beneficiary

are aggregated for the purpose of determining whether the maximum contribution amount has been met. The safe harbor for this limit is the actuarial estimate of five years' educational expenses at the highest-cost undergraduate institution to which attendance is permitted under the program. *See* Prop. Reg. 1.529-2(i)(2).

48 *See* Section 529(c)(3)(C).

49 Prop. Reg. 1.529-5(b)(3)(ii) .

50 See Prop. Reg. 1.529-3(a)(2); *see also* Prop. Reg. 1.529-1(c) (defining a rollover distribution as "a distribution or transfer from an account of a designated beneficiary that is transferred to or deposited within 60 days of the distribution into an account of another individual who is a member of the family of the designated beneficiary").

51 Prop. Reg. 1.529-1(c).

52 *See* Ringel, *supra* note 35, at 385; New York 529 Program Brochure, supra note 42, at 20.

53 Section 529(c)(2)(B).

54 Section 529(c)(4)(C). On a somewhat related point, it is unclear to what extent the designated beneficiary under the Section 529 plan would have to include the account in his or her estate for federal estate tax purposes where amounts are not distributed upon the death of the designated beneficiary. The statute provides that "amounts distributed on account of the death of a beneficiary" are includable in his or her gross estate. Section 529(c)(4)(B). The Proposed Regulations specify that "the gross estate of a designated beneficiary … includes the value of any interest in the [Section 529 plan]." Prop. Reg. 1.529-5(d)(3). As a practical matter, this may not present too great a problem (even assuming that the designated beneficiary were taxable for estate tax purposes on the account balance of the Section 529 plan) because the beneficiary's estate will often be below the applicable exclusion amounts for federal and state estate tax purposes.

55 *See* Section 529(e)(3).

56 *See* Section 529(c)(3)(A).

57 *See* Sections 529(c)(6) and 530(d)(4).

58 Prop. Reg. 1.529-2(e)(1).

59 Prop. Reg. 1.529-5(b)(3)(ii).

60 *Id*.

61 *Id*.

62 *See* Sections 529(c)(3)(A) and 529(c)(3)(C).

63 Prop. Reg. 1.529-5(b)(3)(ii).

64 *Id*.

65 *See* Porter and Gaynor, supra note 25, at H-11.

66 *See* New York 529 Program Brochure, supra note 42, at 17.

67 Reg. 25.2503-6(b)(2).

68 Reg. 1.170A-9(b)(1) .

69 *Id*.

70 *Id*.

71 *See* Rev. Rul. 78-446, 1978-2 CB 257. The tuition exclusion is also available against the GST tax. See Section 2642(c)(3)(B).

72 See Reg. 25.2503-6(c), Example 1 and Reg. 25.2503-6(c), Example 2.

73 Reg. 25.2503-6(a).

74 *See* TAM 199941013 and Ltr. Rul. 200602002.

75 Reg. 25.2503-6(b)(1).

76 Reg. 25.2503-6(b)(2).

77 Section 529(c)(2)(A)(ii).

78 N.Y.C.P.L.R. §5205(j).

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