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Preparing For The Old College Try: Using Tax-Advantaged Strategies to Fund Education Expenses

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Implementing a plan to endow educational funding for successive generations is a simple and tax-advantaged way to provide a lasting legacy for family and loved ones. With education costs rising, several strategies are available to finance education, while minimizing income, gift, estate, and generation-skipping transfer ("GST") taxes.

1. Direct Payment of Tuition

The most straightforward method of financing a loved one's education is to pay tuition directly. If paid directly to an educational institution, such gifts are not subject to gift or GST tax. Consequently, the gift does not deplete the donor's annual exclusion amount ($14,000 per beneficiary or $28,000 when gifts are split between spouses) or the donor's lifetime exclusion amount ($5,430,000 per person, in 2015, indexed to inflation). Tuition payments for all levels of education, from elementary school to graduate school, enjoy this preferential tax treatment, but payment of fees other than tuition (such as room and board or the cost of books) do not qualify.

2. 529 Plans and Coverdell Education Savings Accounts

529 Plans have received a flurry of attention in recent months, due to President Obama's proposal to tax distributions made for qualified education expenses. The proposal was swiftly withdrawn after significant push-back from both Republican and Democratic lawmakers, suggesting that 529 Plans will continue to enjoy favorable tax treatment going forward.

Contributions to 529 Plans grow tax-free, as long as distributions are made for qualified higher education expenses, such as college or graduate school tuition, room and board, books, and school fees. If distributions are made for any purpose other than a qualified education expense, the distributions are considered taxable income to the recipient and are subject to a penalty. Each account may only have a single beneficiary, but the account owner may change the beneficiary designation to the original beneficiary's family members without penalty. The account owner exercises control over all account distributions and, subject to a penalty, may even revoke the account and take back any contributions made up to that point. However, the account owner's control over investment decisions is limited; the plan's administrators manage its investments. Subject to certain limitations, the account owner may switch plans, but may not direct individual investments.

* Admitted only in Pennsylvania and New Jersey; practicing law in the District of Columbia during the pendency of her application for admission to the D.C. Bar and under the supervision of lawyers of the firm who are members in good standing of the D.C. Bar.

Contributions to a 529 Plan are not exempt from gift or GST tax but enjoy other transfer tax advantages. Any individual (not just the account owner) may front-load gifts to a 529 Plan, making five years' worth of annual exclusion gifts in a single year. This allows the account to accrue value more quickly than if a contributor were restricted to gifting only the annual exclusion amount each year. Each 529 Plan sets its own contribution limit, most between $250,000 and $400,000.

Coverdell Education Savings Accounts ("Coverdell Accounts"), also known as Educational IRAs, are similar to 529 Plans but permit distributions for elementary and high school educational expenses, as well as higher education expenses. This flexibility is tempered by stricter income and contribution limits. Unlike a 529 Plan, contributions to a Coverdell Account are capped at $2,000 a year and cannot be accelerated. Individuals with an annual income over $110,000 ($220,000 for a married couple filing jointly) may not establish or contribute to a Coverdell Account. While the income limits are restrictive, such accounts may be useful for younger generations in the early stages of their financial planning or older generations with reduced retirement income.

3. 2503(c) Trust

Another option for individuals looking to provide for their descendants' education is the establishment of a 2503(c) Trust. A 2503(c) Trust is designed to receive annual exclusion gifts on behalf of a minor. The settlor of a 2503(c) Trust has the power to select the trustee, who will direct the trust's distributions and investments. The settlor may retain the power to replace a trustee, providing a level of control not available to 529 Plan and Coverdell Account owners.

The appointed trustee has full control of the trust assets until the beneficiary reaches age twenty-one. The trustee may distribute the assets for any purpose, including education. The beneficiary must be granted the ability to access the trust's assets upon reaching age twenty-one, but the trust may also be designed to continue after the child reaches majority, so long as the beneficiary does not elect to withdraw the trust assets.

4. HEETs

A HEET (Health and Education Exclusion Trust) combines the benefits of an irrevocable trust with the preferential gift tax treatment of direct tuition payments. As with a 2503(c) Trust, the settlor has the power to select, remove and replace the HEET's trustee. Distributions from a HEET may be made to pay tuition for any level of education, from elementary school to graduate school, but cannot be used for other expenses, such as room and board, uniforms, and books. Unlike 529 Plans and Coverdell Accounts, a HEET is able to provide education funding for multiple beneficiaries. Distributions for tuition will be exempt from GST tax, but the HEET must include a charitable beneficiary. The charity's interest may be tailored to fit the settlor's charitable objectives.

A variety of tools are available to finance education in a tax efficient manner. No one tool is right for every family. In our experience, a combination of strategies ensures generations to come have their educational needs met while benefiting from income and transfer tax savings. If you would like more information about the strategies discussed above, please contact your Arnold & Porter attorney.

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