X. EDUCATION AND MEDICAL EXPENSES

A. Introduction

This Chapter discusses various vehicles that may be utilized for payment of education and medical expenses and their tax benefits. Some payments of medical and education expenses are excluded for gift and generation-skipping transfer ("GST") tax purposes, while other medical and education expenses may be paid from various accounts that are allowed to grow tax-free.

Specifically, this Chapter discusses the following topics related to the payment of education and medical expenses:

- Unlimited Exclusion for Tuition Expenses and Medical Expenses Under Internal Revenue Code ("IRC") § 2503(e)
- Qualified Tuition Programs ("QTPs")
- Coverdell Education Savings Accounts ("Coverdell ESAs")
- Comparison of IRC § 2503(e) Exclusions, QTPs, and Coverdell ESAs

B. Brief Overview of GST Tax

A large part of this Chapter discusses the transfer tax consequences (especially the GST tax consequences) of IRC § 2503(e) exclusions, QTPs and Coverdell ESAs. A brief summary of the GST tax follows.

Generally, the GST tax is imposed on any transfer of property in excess of the GST exemption from a transferor to individuals who are more than one generation level younger than the donor, if the donor and the donee are related (*e.g.*, transfers to grandchildren, great-grandchildren, grand-nieces and grand-nephews, and so forth), and if they are not related, if the donee is 37½ years or more younger than the donor. Such donees are called "skip persons." The GST tax applies whether the transfer to the skip person is an outright gift or bequest (a "direct skip"), a distribution to a skip person of income or principal from a trust (a "taxable distribution"), or a distribution to a skip person on the termination of a trust (a "taxable termination"). The GST tax is imposed on non-exempt transfers at a rate equal to the maximum estate tax rate, and is assessed in addition to any federal gift tax or estate tax that may be imposed on the transfer.

An outright gift to a skip person that qualifies for the federal gift tax annual exclusion will also be exempt from GST tax. A gift in trust for a skip person, however, will not be exempt from GST tax unless the skip person is the sole beneficiary of the trust and the trust will be included in the skip person's gross estate for federal estate tax purposes.

Under current law, tGST exemption will he GST tax is not applicable to transfers or decedents dying in 2010. In 2011, the GST tax returns, and transfers with a value above a $1 million be taxed at a 55% rate. The GST exemption will be indexed for inflation.

C. Unlimited Exclusion for Tuition Expenses and Medical Expenses Under IRC § 2503(e)

1. General

IRC § 2503(e) excludes from gift tax certain "qualified transfers," which include amounts paid by a donor to a qualifying educational organization (as defined under IRC § 170(b)(1)(A) and Treas. Reg. §§ 1.213-1(3)(1)(ii), 25.2503-6(b)(2)) on behalf of an individual for tuition expenses or to a medical care provider for medical care expenses (as defined under IRC § 213(d) and Treas. Reg. § 25.2503-6(b)(3)). The amount of the exclusion for such tuition and medical expenses is unlimited, and the exclusion is *in addition to* the gift tax annual exclusion. Treas. Reg. § 25.2503-6(a). Gifts that qualify for the exclusion for tuition or medical expenses are considered nontaxable gifts and are not subject to GST tax. IRC §§ 2611(b)(1) and 2642(c)(3)(B). Over time, these transfers for tuition and medical care can remove significant amounts from the donor's gift and estate tax base. These gifts may be an important estate planning technique for those donors of more modest wealth who feel they can afford to make these payments given their important purposes.

Payments of tuition expenses must be made *directly* to the educational institution to qualify for the exclusion. Similarly, payments of medical expenses must be made *directly* to the medical care provider to qualify for the exclusion. IRC § 2503(e)(2). As the donee need not be a relative of the donor in order to qualify for the exclusion for tuition and medical expenses, the number of potential donees is unlimited.

2. Definitions

a. <u>Qualified Transfer</u>. A "qualified transfer" is defined as payment on behalf of an individual for: (1) tuition expenses incurred at a qualifying educational organization described in IRC § 170(b)(1)(A); (2) for the education or training of such individual; or (3) medical care, as defined in IRC § 213(d), paid to the provider of medical services.

b. <u>Qualifying Educational Organization</u>. A "qualifying educational organization" is 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 the education activities are regularly carried on. Treas. Reg. § 25.2503-6(b)(2). The term includes primary, secondary, preparatory or high schools, and universities or colleges. Treas. Reg. § 1.170A-9(b). The tuition expenses may be paid on behalf of a part-time or full-time student. The payments must be made, however, directly to such qualifying educational organization. Only tuition expenses qualify for the exclusion for education expenses. Expenses for books, supplies, dormitory fees, board, or other similar expenses do *not* qualify for the exclusion. Treas. Reg. § 25.2503-6(b)(2).

➔ **<u>Planning Point</u>:** Qualifying educational organizations also may include day-care centers and pre-schools if they meet the above requirements. <u>See</u> Rev. Rul. 78-446; PLR 7942038 (both focusing on the day-care or pre-school's primary function of the presentation of formal instruction).

The Internal Revenue Service ("IRS") has held that prepayment of tuition may qualify as a qualified transfer if certain requirements are satisfied. <u>See</u> PLR 199941013. In this PLR, the IRS listed the following facts as determinative of qualification for a prepayment:

- The prepayment must be made directly to the qualifying educational organization.
- The prepayment was made on behalf of a designated beneficiary for specified tuition costs.
- The prepayment was nonrefundable and subject to forfeiture if the designated beneficiary did not attend the school.

➔ **Planning Point:** Payments to a qualified tuition program under IRC § 529, however, do not satisfy the requirements of IRC § 2503(e).

c. Qualifying Medical Expenses. "Qualifying medical expenses" include expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. In addition, amounts paid for medical insurance, transportation for and essential to medical care, and qualified long-term care services qualify. The exclusion does not apply, however, with respect to any amounts reimbursed by medical insurance. Treas. Reg. § 25.2503-6(b)(3). A nonexclusive list of services that qualify as medical care is provided in Treas. Reg.§ 1.213-1(e)(1)(ii). The expenses must be incurred for more than a mere benefit to the general health of an individual. For example, a vacation that promotes healthy living is not an expenditure for medical care. See Treas. Reg. § 1.213-1(e)(ii). It also is possible for part or all of a capital expenditure to qualify as a medical expense if the expenditure has as its principal purpose medical care.

> **EXAMPLE:** A physician advised that Beneficiary needed a detachable air conditioner installed for medical reasons related to Beneficiary's lung condition. The full cost of the air conditioner, including related installation costs, would qualify as a medical expense. If a donor paid the air conditioner company directly, such payment would qualify under IRC § 2503(e) as an excludible medical expense.

3. GST Tax Advantages

Under IRC § 2611(b), transfers that are nontaxable gifts pursuant to IRC § 2503(e) are not subject to GST tax.

➔ **Planning Point:** The IRC § 2503(e) exclusion is especially valuable for grandparents because their payments of a grandchild's tuition and medical expenses: (a) are unlimited in amount; (b) are free of gift tax; (c) are free of GST tax; and (d) remove significant amounts from their estates. In addition, the grandparents control the use of the gifts by making payments directly to the educational institution or medical provider.

4. Use of Trusts

Generally, a transfer of funds from a donor to a trust that provides for the distribution of income and/or principal to cover tuition costs incurred by the trust beneficiaries is not a direct transfer to a qualifying educational organization, and therefore does not qualify as a qualifying

transfer under IRC § 2503(e), or for the exclusion from GST taxation under IRC § 2611(b).

> **<u>EXAMPLE</u>:** Donor transferred $50,000 to a trust which allows the trustee to make distributions of income and principal for tuition expenses incurred by Donor's grandchild. The transfers from the trust to the qualifying educational organization meet the requirements of IRC § 2503(e). The transfer to the trust by the Donor, however, does not qualify for IRC § 2503(e) treatment, and if the Donor's grandchild is the only beneficiary, the transfer is considered a direct skip for GST purposes and is subject to GST tax. <u>See</u> Treas. Reg. § 25.2503-6(c), Ex. 2.
>
> Contributions to such a trust which do not exceed the annual exclusion amount under IRC § 2503(b) and which are subject to "*Crummey*" withdrawal rights held by the skip person-beneficiary will be exempt from gift tax under IRC § 2503(b). Additionally, such contributions will not be subject to GST tax because the trust will have a zero inclusion ratio under IRC § 2642(c) if the grandchild is the only beneficiary and any amounts remaining in the trust at the grandchild's death are includible in the grandchild's gross estate.

It is possible to structure a trust for more than one beneficiary so that it is exempt for gift and GST tax purposes. A donor can make a transfer to a trust that provides that the trustee may distribute funds only to cover tuition expense payments to qualified educational organizations or for medical care payments to a medical services provider as specified in IRC § 2503(e) (these trusts are sometimes referred to as health and education exclusion trusts ("HEET")). The distributions from such a trust to a qualified educational organization or to a medical services provider will meet the requirements of IRC § 2503(e). In order for the initial transfer from the donor to the trust to qualify as nontaxable for gift tax purposes, however, the beneficiaries must have *Crummey* withdrawal rights that qualify the transfer for the IRC § 2503(b) gift tax annual exclusion.

For GST tax purposes, if a transfer is made to a trust where skip persons, such as grandchildren, are the only beneficiaries, such transfer is a direct skip subject to immediate GST taxation. In order for the transfer to be nontaxable for GST tax purposes, the trust, as initially created, must include beneficiaries who are <u>not</u> skip persons. To accomplish this, a child of the donor could be a beneficiary of the trust, thereby giving a non-skip person an interest in such trust. Therefore, the transfer from the donor to the trust would not be a direct skip, and would not be subject to GST tax. Upon the death of the child, however, if the only beneficiaries are skip persons, the death of the child would be considered a taxable termination subject to GST tax.

If a charity is named as a beneficiary of the trust and the charity receives more than a nominal interest in such trust, the trust will not qualify as a skip person as the charity is assigned to the same generation level as the donor. The interest provided for the charity must be intended to truly benefit the charity to overcome the nominal limitation of IRC § 2652(c)(2). <u>See</u> Treas. Reg. § 26.2612-1(e)(2)(ii).

In addition to the above considerations, it is possible for such a trust to run afoul of the separate share rules. If a charity's interest can be separated from the non-charitable interest in the trust, the charitable and non-charitable interests are considered separate shares. The non-charitable share may be considered a skip person, thereby defeating the GST tax exempt nature of such trust. To avoid the separate share rules, the charity must be provided an interest that cannot be separated from the non-charitable interest, such as the right to receive all the income for several years and then a certain percentage of the income in future years.

EXAMPLE:

Facts: Donor creates a trust, the beneficiaries of which are Donor's grandchildren and Charity. The grandchildren are given *Crummey* withdrawal rights over contributions received by the trust. The charity is given an interest in the annual income from such trust which cannot be separated from the non-charitable interest as stated above. Distributions from the trust are permitted for the benefit of the grandchildren only to the extent such distributions qualify as tuition or medical expenses under IRC § 2503(e). If the assets of the trust are not fully utilized by the grandchildren and their descendants, such remaining assets will be distributed to Charity.

Results:

Transfers by Donor to Trust: Provided the transfers do not exceed the annual exclusion amount each year for any beneficiary, such transfers are excluded for gift tax purposes under IRC § 2503(b) as a result of the *Crummey* withdrawal powers of each beneficiary. Because a non-skip person (Charity) has an interest in the trust, the initial transfer is not a direct skip and is not subject to GST tax. Therefore, the initial transfers to the trust are not subject to gift tax or GST tax.

Transfers from the Trust: Under the trust, only transfers to the non-charitable beneficiaries that qualify under IRC § 2503(e) are permitted. Therefore, the distributions from the trust for tuition or medical expenses are not subject to GST tax under IRC § 2611(b)(1).

5. Advantages and Disadvantages of Exclusion for Tuition Expenses and Medical Expenses

There are several advantages of the exclusion under IRC § 2503(e). First, the donor can retain ultimate control and actual use of the assets until actual payments are made for such expenses. Also, a donor can withhold payment of expenses until expenses are actually incurred. Because payments for educational and medical expenses are not considered taxable gifts, those payments do not utilize the donor's gift tax annual exclusion or gift tax exemption, and can be structured to be nontaxable gifts for GST tax purposes. A disadvantage of IRC § 2503(e) is that non-tuition expenses (such as room and board expenses) are not qualified education expenses excluded from gift tax.

C. Qualified Tuition Programs

1. Introduction

In 1996, Congress enacted IRC § 529, which exempts a "qualified tuition program" ("QTP") from federal income taxation, except for the tax on unrelated business income, and provides rules for the taxation of donors and beneficiaries. Proposed regulations, in addition to several statutory amendments, have expanded the tax benefits available. IRC § 529 applies to QTPs established by a state or an agency or instrumentality of a state or by one or more "eligible educational institutions" as either a prepaid tuition program or an education savings account ("529 ESA") program. IRC § 529(b)(1). Today, every state has one or both types of these programs, and many state programs are open to nonresidents. Most states provide an incentive for taxpayers to participate in the state's own 529 plan, such as state income tax deductions. As of June 2006, there were $93 billion held in plans established under IRC § 529.

Under a prepaid tuition program, an individual purchases tuition credits or certificates on behalf of a beneficiary to prepay tuition and fees while locking in current tuition rates. These plans are designed to hedge the increasing cost of higher education. The prepaid tuition programs may be established and maintained by state programs or by eligible private institutions that satisfy the requirements of IRC § 529.

Under a 529 ESA, an individual contributes to a state's savings account, established to pay for the designated beneficiary's "qualified higher education expenses" at an "eligible educational institution." These terms are defined below. These programs usually are managed by professional investment companies and have various investment options. The primary investment option is a managed allocation, age-based approach, whereby assets are shifted from equities to more conservative fixed-income investments as the child approaches college age. Neither the account owner nor the designated beneficiary may directly or indirectly participate in investment decisions regarding a QTP. IRC § 529(b)(5). The IRS, however, does allow the account owner to select an investment strategy upon establishing the account and to change investment options once per calendar year and upon a change in the designated beneficiary of the account. Prop. Reg. § 1.529-2(g); Notice 2001-55, 2001-2 C.B. 299. (IRC § 529 programs and participants may rely on this Notice only upon the issuance of final regulations under IRC §529). Some states have added single-fund options to their portfolio choices, which allow account owners to exert more control over the investment of the 529 plan assets.

The following is a summary of the federal law regarding the requirements of both types of QTPs. Each state has its own program with its own rules and regulations, and the practitioner is encouraged to study each state's plan that he or she may be considering for the benefit of a client.

2. Definitions

a. **Qualified Higher Education Expenses**. "Qualified higher education expenses" include costs of tuition, fees, books, supplies, equipment required for enrollment or attendance at an eligible educational institution (including a graduate school at such institution),

and expenses for "special needs services" of a "special needs beneficiary" incurred "in connection with such enrollment or attendance." IRC § 529(e)(3)(A)(ii). For students enrolled for at least one-half of a full-time load, qualified higher education expenses also include costs of "room and board while attending such institution" up to the greater of (1) the allowance for room and board in the institution's budget for federal financial aid or (2) "the actual invoice amount the student residing in housing owned or operated by the eligible educational institution is charged by such institution for room and board costs for such period." IRC § 529(e)(3).

b. **<u>Eligible Educational Institution</u>**. An "eligible educational institution" is an accredited, post-secondary education institution offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree or other recognized post-secondary credential. IRC § 529(e)(5). According to the IRS, "virtually all accredited public, nonprofit, and proprietary postsecondary institutions" are eligible educational institutions. Notice 97-60, 1997-2 C.B. 310.

➔ **<u>Planning Point</u>:** Costs of attending high school, junior high school, elementary school and pre-school are *not* covered by QTPs.

c. **<u>Account Owner</u>**. The "account owner" is the individual entitled to select or change the designated beneficiary and to designate any person (including the account owner) other than the designated beneficiary to whom funds may be paid from the account. Prop. Reg. § 1.529-1(c). In contrast to a Uniform Gifts to Minors Act or a Uniform Transfers to Minors Act ("UTMA") account, the account owner always has complete control and ownership over the QTP. The designated beneficiary never has direct access to the account. Beneficiary changes can occur at any time and as often as desired. However, as discussed below, beneficiary changes may be subject to taxes and penalties. Also, the account owner cannot use an account or an interest under the QTP as security for a loan.

The account owner may also retain the right to terminate the account and refund the account funds to him or herself. For example, if a designated beneficiary decides not to go to college, the account owner can defer use of the account, change beneficiaries or withdraw the assets (subject to income tax and a 10% penalty).

➔ **<u>Planning Point</u>:** Some states permit persons other than the account owner to make contributions, and some states permit a change in the identity of the account owner. The account owner is not always a donor; any entity, including a trust, can be an account owner. Any asset may be used to establish the trust, including real estate, appreciated stock or bonds. Depending on the nature of the asset contributed, a valuation discount for such asset may be obtained. Such a trust could have a purpose of making distributions of cash to the QTP for the benefit of the designated beneficiary, although it should have other purposes. Gift tax (and possibly GST tax) may apply to the initial transfer to such a trust and to the transfer by the trustee to the 529 ESA. <u>See</u> Michael Schlesinger, "Qualified State Tuition Programs: More Favorable After 2001 Tax Act," 28 Est. Pln. 412 (Sept. 2001).

After the account owner's death, the account will then be controlled by the account owner's designee, as stated in the plan form or in the account owner's will. To prevent the beneficiary from inheriting the account with full control, the owner could name a trust as the successor owner with restrictions in the trust instrument regarding how the funds in the QTP are to be expended.

d. **Designated Beneficiary**. A "designated beneficiary" is defined as: (1) the individual designated as the beneficiary when the account is established; (2) the new beneficiary when a beneficiary change is made; or (3) the individual who receives the benefits accumulated in the account as a scholarship in the case of a 529 ESA purchased by a state or local government or an IRC § 501(c)(3) charitable organization as part of a scholarship program operated by such government or organization. IRC § 529(e)(1). The designated beneficiary (if not the account owner) need not be related to the account owner. The program must keep a separate account for each designated beneficiary.

3. Contribution Rules

Only cash contributions are permitted. There are no age, time or income limitations applicable to investing in or owning a QTP. Contributions to a QTP are not deductible for federal income tax purposes, but most states allow a state income tax deduction for a limited amount of contributions. Contribution limits generally are between $250,000 and $300,000 and vary from state to state.

➔ **Planning Point:** Most states allow a transfer of existing Coverdell Education Savings Accounts ("Coverdell ESAs") and UTMA accounts to a 529 ESA. Because the beneficiary is considered the owner of those accounts, however, certain restrictions will apply to such a 529 ESA. For example, the 529 ESA can be used only for the benefit of the original designated beneficiary, and no distribution can be made to the initial donor of the Coverdell ESA or UTMA. See generally, David M. Pfefferkorn, "The Investment of Custodial Funds in Section 529 Qualified Tuition Programs: Tax Advantages and Fiduciary Concerns," 30 Est. Pln. 571 (Nov. 2003).

There is no limit on account growth; earnings on a QTP are not taxable to the account owner or the designated beneficiary for federal income tax purposes at least as long as they remain in the plan.

A QTP must have adequate procedures in place to prevent contributions in excess of those necessary to provide for the qualified higher education expenses of the designated beneficiary. The regulations provide a "safe harbor" for this requirement that states that the QTP must bar any additional contributions to an account once the account reaches a specified account balance limit. Total contributions under this safe harbor may not exceed the amount determined by actuarial estimates that is necessary to pay tuition, required fees and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program. Prop. Reg. § 1.529-2(i).

4. Distribution Rules

Distributions from a QTP or prepaid tuition program made for qualified higher education expenses are excluded from the designated beneficiary's gross income for federal income tax purposes. IRC § 529(c)(3). For purposes of the exclusion, qualified higher educational expenses are reduced by (1) scholarships excluded from gross income under IRC § 117, various federal educational assistance allowances and any excludable payment (other than a gift or inheritance) covering the educational expenses and (2) any portion of the expenses "taken into account in determining" the Hope Scholarship or Lifetime Learning Credit. Scholarship funds may be withdrawn income tax and penalty free.

➔ **Planning Point:** If a Coverdell ESA is also utilized, the remaining expenses must be allocated among the QTP and the Coverdell ESA. IRC § 529(c)(3)(B)(iv).

The earnings portion (as determined under IRC § 72) of any distribution that is not used for qualified higher education expenses is subject to a 10% penalty, along with ordinary income tax treatment. The penalty and income tax is paid either by the account owner or the designated beneficiary, depending on who initiated the withdrawal. IRC § 529(c)(3)(A) and (c)(6). A state may also tax and penalize such distributions. The penalty is waived if the distribution is made after the designated beneficiary's death or becoming disabled or is made on account of the designated beneficiary's qualified expenses being covered by a scholarship, federal education assistance allowance or other payment excluded from gross income. Prop. Reg. § 1.529- 2(e)(4)(ii)(B). To facilitate the inclusion of income, the program must file an annual information return with the IRS and make an annual report to the distributee. IRC § 529(d); Prop. Reg. § 1.529-4. No other amount is included in the gross income of the donor or designated beneficiary. IRC § 529(c)(1).

Each plan must have procedures for verifying the use of distributions. The proposed regulations provide a "safe harbor" for such procedures, which includes having payments made directly to an eligible educational institution or requiring the designated beneficiary to provide substantiation that payments are in reimbursement for qualified higher education expenses. Prop. Reg. § 1.529-2(e)(4)(ii).

> **EXAMPLE:** X contributes $10,000 to a QTP. In six years, that amount has grown to $15,000. Two withdrawals are made: $7,500 for qualified higher education expenses and $7,500 for a vacation. The $7,500 withdrawn for college expenses is tax-free. Regarding the vacation withdrawal, $2,500 is treated as a withdrawal of earnings (the proportionate amount of the total earnings). This amount is taxed as ordinary income. In addition, there is a 10% penalty attached to this amount. No other amount is taxed.

5. Federal Gift and GST Tax Treatment

A contribution to a QTP is treated as a completed gift and may be subject to gift tax. IRC § 529(c)(2). However, the donor can elect to contribute up to five times the gift tax annual

exclusion limit in one calendar year without making a taxable gift (i.e., $65,000 in 2010 or $130,000 if gift-splitting between spouses is elected). IRC § 529(c)(2)(B); Prop. Reg. § 1.529-5(b)(2). Upon the election, if the total contributions by a donor in a particular calendar year are in excess of the $13,000 gift tax annual exclusion amount, the total contributions for that year can be taken into account ratably over five years beginning with the calendar year of contribution. The election to do so must be made on the donor's United States Gift and Generation-Skipping Transfer Tax Return (Form 709). Unless state law provides otherwise, no distribution from a QTP is treated as a taxable gift.

➔ **Planning Point:** If the donor makes a contribution of five times the annual exclusion amount in Year 1, and makes the above election, the donor cannot make additional annual exclusion gifts to the same donee in Years 2, 3, 4 and 5, except to the extent the annual exclusion is adjusted for inflation in one or more of those years.

➔ **Planning Point:** Contributions to a QTP are not qualified transfers for education expenses under IRC § 2503(e).

6. Rollovers and Changes of Beneficiary

The account owner can make a tax-free rollover of a distribution from a QTP if, within 60 days after the distribution, the distribution is rolled over to another QTP to the credit of the same beneficiary or is transferred to a QTP for another beneficiary who is a member of the family of the previous beneficiary and is in the same generation as (or in a higher generation than) the previous beneficiary. IRC § 529(c)(3)(C)(i) and (c)(5)(B). Only one rollover is allowed during a 12-month period. A rollover can be an effective way to handle a situation in which the original designated beneficiary cannot use the funds for education or when the account owner wants to exert more control over investments.

Under IRC § 529(e)(2), "member of the family" is defined as a person who has the following relationship to the previously designated beneficiary: (a) a child or other descendant; (b) a stepchild; (c) a sibling, half-sibling or step-sibling; (d) a parent or other ancestor; (e) a step-parent; (f) a nephew or niece; (g) an uncle or aunt; (h) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law; (i) a spouse of any individual listed above or the spouse of the designated beneficiary; or (j) a first cousin.

In addition to a rollover, the account owner can make a tax-free designation of a new beneficiary if the new beneficiary is a member of the family of the previous beneficiary and is assigned to the same generation as (or a higher generation than) the previous beneficiary. IRC § 529(c)(3)(C)(ii) and (c)(5)(B); Prop. Reg. § 1.529-5(b)(3).

If a rollover is made to a new beneficiary or a designation of a new beneficiary is made, and the new beneficiary is assigned to a lower generation level than the previous beneficiary, a taxable gift is made from the previous beneficiary to the new beneficiary even if the new beneficiary is a member of the family of the previous beneficiary. Such a gift is still eligible for the gift tax annual exclusion and the 5-year averaging rule. If the new beneficiary is more than

one generation lower than the previous beneficiary, such a gift is subject to GST tax as well as gift tax. IRC § 529(c)(5)(B); Prop. Reg. § 1.529-5(b)(3)(ii). If the new beneficiary is not a member of the previous beneficiary's family, income and gift tax, in addition to a 10% penalty, will be due on the accumulated earnings portion of the transfer.

> **EXAMPLE:** In year one, P makes a contribution to each of two 529 ESAs for the benefit of P's children, A and B. P directs distributions from A's account to be made for A's qualified higher education expenses. Because B never attends an eligible educational institution, no distributions are made from B's account. P then rolls over the assets in B's account to an account for the benefit of A's child, D (B's nephew). Pursuant to the regulations, B is treated as making a taxable gift to D for the entire amount of the account, even though B had no control over the gift B is deemed to have made. The gift, however, is eligible for the gift tax annual exclusion and the 5-year averaging rule.

7. Federal Estate Tax Treatment

Even though the account owner retains the right to change the designated beneficiary or the right to terminate and receive a refund of the account, the account assets are excluded from the account owner's gross estate for federal estate tax purposes. IRC § 529(c)(4)(A); Prop. Reg. § 1.529-5(d)(1). If a donor elects to spread contributions over 5 years as discussed above, the portion of the excess contributions allocable to calendar years beginning after the donor's date of death will be included in the donor's gross estate for federal estate tax purposes. IRC § 529(c)(4)(C); Prop. Reg. § 1.529-5(d)(2).

➔ **Planning Point:** Even though a portion of the contribution may be includible in the account owner's gross estate, only the unamortized gifts are included, and any appreciation in value of or earnings generated by the gifted funds are not includible.

> **EXAMPLE:** On December 1, 2010, W establishes a 529 ESA account and funds it with $65,000. W's child is the designated beneficiary of the account. No gift tax results from this transfer. W makes the election to spread the $65,000 ratably over five years for gift tax purposes. If W dies on January 1, 2012, $26,000 is excluded from her gross estate but $39,000 is included in her estate.

The value of the account is, however, included in the gross estate of the designated beneficiary for federal estate tax purposes if amounts are distributable on account of the death of the designated beneficiary. IRC § 529(c)(4)(B); Prop. Reg. § 1-529-5(d)(3).

8. Effect on Financial Aid

A 529 ESA and a pre-paid tuition program generally are treated as an asset of the account owner (usually the parents) for financial aid purposes. Therefore, if the student is not the donor,

the account does not count as an asset of the student. When calculating the parental contribution under the Free Application for Federal Student Aid, however, a certain percentage of the 529 ESA or pre-paid tuition program is included in such calculation (5.64% maximum for 2007).

Additionally, a tax-free distribution from a 529 plan to pay this year's college expenses will not be part of the "base-year income" that reduces next year's financial aid eligibility.

9. Advantages and Disadvantages

a. **Advantages**. The advantages of QTPs include the following:

- Funds contributed grow tax-free.
- Anyone may participate in a QTP.
- A donor may generally contribute any amount to a QTP.
- Contributions to a QTP are gifts of a present interest which can qualify for the federal gift tax annual exclusion.
- Up to five years' annual exclusion gifts may be made to a QTP in a single funding.
- Even though the account owner can retain some control over the assets (even after the beneficiary reaches the age of majority), the value of the account assets are usually excluded from the account owner's gross estate for federal estate tax purposes.
- The account owner also may retain the right to terminate the account or to change the beneficiary.
- Earnings on a 529 ESA will not be taxed to the account owner or the designated beneficiary for income tax purposes as long as the withdrawals from the account are used for qualified higher education expenses, and the contributions grow tax-free.
- Some states offer state income tax deductions for contributions to a QTP.

b. **Disadvantages**. The disadvantages of QTPs include the following:

- Only after-tax cash contributions may be made to a QTP.
- The account owners and the designated beneficiaries lack complete control over investment decisions.
- Although the donor may select from a range of investment options similar to a 401(k) account, the donor does not have the same ability to change the investment options as the donor has with respect to the donor's own funds or a custodial account for a minor beneficiary.
- An interest in a QTP may not be pledged as security. Prop. Reg. § 1-529-2(h).
- The law surrounding QTPs has changed significantly over the last few

years, and some of the rules and regulations are still being developed.

c. <u>Pre-Paid Tuition Programs vs. 529 ESAs</u>. Under pre-paid tuition programs, individuals purchase tuition credits or certificates on behalf of a beneficiary to prepay tuition and fees while locking in current tuition rates. A contribution to this type of plan purchases a specific amount of future tuition (<u>e.g.</u>, 12 credit hours). As discussed above, the funds held in the account are considered a resource to the student when determining the student's need for financial aid.

By using a 529 ESA, the amount of funds available to the beneficiary for education purposes is dependent on how the account was invested and how such investments performed. It is possible that the funds will not be sufficient to cover the education costs of the beneficiary. As stated above, the 529 ESA is treated as an account of the donor (typically the parents) for financial aid purposes.

D. Coverdell Education Savings Accounts

1. General

Another device for contributing to another individual's education is a Coverdell Education Savings Account ("Coverdell ESAs"), formerly called an Education IRA. A Coverdell ESA is created to pay "qualified education expenses" of the designated beneficiary.

a. <u>Qualified Education Expenses</u>. "Qualified education expenses" include "qualified higher education expenses" and "qualified elementary and secondary education expenses."

b. <u>Qualified Higher Education Expenses</u>. "Qualified higher education expenses" include tuition, fees, books, supplies and equipment required for the enrollment or attendance of a beneficiary at a post-secondary educational institution. They also include contributions to a QTP on behalf of the beneficiary. Qualified higher education expenses include costs of room and board.

c. <u>Qualified Elementary and Secondary Education Expenses</u>. "Qualified elementary and secondary education expenses" include tuition, fees, academic tutoring, books, supplies, computer equipment and other equipment in connection with the enrollment of the beneficiary at a public, private or religious school. They also include costs of room and board, uniforms, transportation, and the purchase of computer technology or equipment or Internet access if they are to be used while the beneficiary is in school.

➔ **<u>Planning Point</u>:** Expenses for special needs services for a special needs beneficiary are included in the definitions of qualified higher education expenses and qualified elementary and secondary education expenses if such expenses are incurred in connection with enrollment and attendance at an eligible institution. IRC § 530(b)(2) and (4).

2. **Contribution Rules**

The amount a donor can contribute to a Coverdell ESA is limited. Through 2010, a donor may make nondeductible cash contributions to a Coverdell ESA of up to $2,000 per year per beneficiary. The $2,000 limit applies in the aggregate to all Coverdell ESAs for the same beneficiary whether the contributions were made by one or more donors. IRC § 530(b)(1)(A).

> **EXAMPLE:** Grandparent created a Coverdell ESA for Grandchild and contributed $1,500. Parent also created a Coverdell ESA for Grandchild (Parent's child) in the amount of $1,000. The Coverdell ESA allowance for Grandchild is over-funded, and an excess contribution of $500 is created.

The donor's adjusted gross income may reduce the allowable contribution amount. Through 2010, the amount a single taxpayer can contribute to a Coverdell ESA is reduced beginning at $95,000 of adjusted gross income and completely phased out at $110,000, whereas the amount that a married couple filing jointly can contribute is reduced beginning at $190,000 and completely phased out at $220,000 of adjusted gross income. Entities are not subject to the adjusted gross income limitations. IRC § 530(c)(1).

Contributions to a Coverdell ESA must be made in cash and cannot be made after the beneficiary reaches age 18. IRC § 530(b)(1)(A). The account may remain open, however, until the child turns 30, at which time any balance remaining in the account must be distributed. IRC § 530(b)(1)(E). Contributions for a special needs beneficiary may be made after such beneficiary reaches age 18, and mandatory distribution at age 30 is not required. IRC § 530(b)(1).

Contributions are permitted until the return due date for the tax year of the contribution, not including extensions. A tax is assessed on excess contributions. If the excess contribution is withdrawn by such date and the net income attributable to such distribution also is distributed, such distribution will not be subject to the 10% penalty. IRC § 530(d)(4)(C).

> **EXAMPLE:** In 2007, Donor contributed $2,500 to a Coverdell ESA for Beneficiary. Contributions are limited to $2,000 in 2007. Therefore, Donor made an excess contribution of $500. The earnings on the $500 excess distribution in 2007 amounted to $50. If Donor withdraws the $500 plus the $50 in earnings on or before May 30, 2008, the 10% penalty will not be assessed on such distribution. The
>
> $50 earnings distribution will be includible in Donor's gross income for 2007.

3. **Distribution Rules**

In contrast to the 529 ESA, the Coverdell ESA must be administered solely for the benefit of the designated beneficiary, and all distributions must be made to or for the benefit of the

beneficiary. No distributions may be made to the account owner. Distributions are tax-free if such distributions are made for qualified higher education expenses. IRC § 530(d)(2)(A). If a distribution is in excess of qualified higher education expenses incurred for the designated beneficiary, the earnings portion of such excess distribution is subject to income tax as ordinary income and a penalty of 10%. IRC § 530(d)(2)(B).

> ➔ **Planning Point:** If qualified higher education expenses are being paid with distributions from both a 529 ESA and a Coverdell ESA, such expenses must be allocated between both accounts. A double distribution is not permitted. IRC § 530(d)(2)(D).

> ➔ **Planning Point:** If a client also is utilizing the Hope or Lifetime Learning Credit, such use will impact the amount of tax-free withdrawals from a Coverdell ESA. IRC § 530(d)(2)(C).

A change of a designated beneficiary to a member of the family of the previous beneficiary (as earlier defined) is not subject to income tax or a penalty if the new beneficiary is under the age of 30. IRC § 530(d)(6). Additionally, a distribution as a result of the death or permanent disability of a designated beneficiary or the receipt of a scholarship by the designated beneficiary is not subject to the 10% penalty, but the earnings portion of such distribution will be included in gross income. IRC § 530(d)(4)(B). The income tax consequence can be avoided if a new designated beneficiary is provided who is a family member of the previously designated beneficiary. IRC § 530(d)(7). An account may be rolled over into another Coverdell ESA once during each 12-month period without incurring any income tax or penalties. IRC § 530(d)(5).

> ➔ **Planning Point:** The assets of a Coverdell ESA can be transferred to a QTP if such program is for the benefit of the same designated beneficiary and the account is established within the same taxable year.

4. Federal Income Tax Treatment

Contributions to a Coverdell ESA are not income tax deductible. Earnings on contributions to a Coverdell ESA, however, are not taxed when earned. IRC § 530(a). If distributions equal the amount of qualified education expenses, then the distributions are not included in the beneficiary's gross income. IRC § 530(d)(2)(A). If the amount of distributions exceeds the qualified education expenses during the taxable year, then the earnings portion of the distribution will be included in the beneficiary's gross income. IRC § 530(d)(2)(B).

Additionally, with limited exceptions, there is a 10% penalty imposed to the extent that a distribution from a Coverdell ESA is includible in gross income. IRC § 530(d)(4)(A). When a beneficiary reaches age 30 and the account is distributed, the earnings portion of the distribution will be included in the beneficiary's gross income and subject to an additional 10% penalty because the distribution is not for education purposes.

A distribution from a Coverdell ESA that is rolled over into another Coverdell ESA for the

benefit of the same beneficiary or a member of the beneficiary's family who has not reached age 30 is excluded from income. IRC § 530(d)(5). Additionally, a change in the beneficiary is not treated as a distribution and not subject to income tax if the new beneficiary is a member of the family of the old beneficiary and has not reached age 30. IRC § 530(d)(6).

5. Federal Gift Tax and GST Tax Treatment

The IRS has not issued Regulations regarding the gift tax and GST tax consequences of a Coverdell ESA. The rules, however, should be similar to those for QTPs. A contribution to a Coverdell ESA is a completed gift and qualifies for the gift tax annual exclusion and exemption from GST tax. Generally, no distribution from a Coverdell ESA is treated as a taxable gift.

A rollover to an account for a new beneficiary or a designation of a new beneficiary will not be subject to gift tax or GST tax if the new beneficiary is in the same generation as the previous beneficiary. If the new beneficiary is not more than one generation level lower than the designated beneficiary, the rollover is subject to gift tax but not GST tax. However, if the new beneficiary is two or more generation levels lower than the designated beneficiary, the rollover is subject to both gift tax and GST tax.

6. Federal Estate Tax Treatment

Generally, the value of the Coverdell ESA is not included in the gross estate of the donor. Amounts distributed on account of the death of the designated beneficiary are included in the beneficiary's gross estate.

7. Effect on Financial Aid

A Coverdell ESA is considered an asset of the beneficiary for financial aid purposes. Any distributions which are included in taxable income will be included in the calculation of financial aid in the year following the distribution, thereby reducing the amount of financial aid received.

8. Advantages and Disadvantages

The advantages of Coverdell ESAs include the following:

- Funds contributed to a Coverdell ESA grow tax-free.
- Distributions from a Coverdell ESA are income tax-free if used entirely for education expenses.
- Distributions from a Coverdell ESA may be used for elementary and secondary education expenses along with higher education expenses.
- A donor has greater control over the investments of a Coverdell ESA than a QTP.

The disadvantages of Coverdell ESAs include the following:

- Contributions that are not used for qualified higher education expenses must be distributed to the beneficiary as opposed to the option of distributing such funds to the account owner under a QTP.
- Any assets remaining in the account when the beneficiary attains the age of 30 must be fully withdrawn or such assets will be subject to income tax and penalties.
- Coverdell ESAs could count against the beneficiary when applying for financial aid.
- Contributions currently are limited to $2,000 a year per child.
- There is an adjusted gross income limit for participants.

E. Comparison of Section 2503(e) Exclusions, Section 529 QTPs, and Coverdell ESAs

The following chart summarizes various characteristics of the above plans. The chart is intended as a generalization, and the practitioner is encouraged to review the appropriate sections of the Internal Revenue Code and not to rely solely on the following chart:

	Section 2503(e) Exclusions	**Section 529 QTPs**	**Coverdell ESAs**
Ownership/Control of Account	Donor.	Donor.	Donor controls on behalf of the beneficiary.
Guidelines for Use	Must be for tuition paid to a qualifying educational institution or payment to a provider for medical care under § 213(d).	Must use for qualified higher education expenses at participating accredited post-secondary schools anywhere in the U.S.	Must use for qualified elementary, secondary or higher education expenses by the time beneficiary turns 30.
Annual Contribution Limit	Unlimited exclusion and in addition to gift tax annual exclusion.	Unlimited contributions (except for specific program limitations) but amount over the annual exclusion subject to gift tax. Contribution greater than annual exclusion may be ratably taken over 5 years.	$2,000 per designated beneficiary under 18.

	Section 2503(e) Exclusions	**Section 529 QTPs**	**Coverdell ESAs**
Adjusted Gross Income Limit	None.	None.	Single: $95-110K Joint: $190-220K
Taxation of Earnings	Not applicable.	Tax-free growth. Qualified distributions are federal income tax- free. State tax varies.	Tax-free growth. Qualified distributions are federal income tax-free. State tax varies.

Taxation/Penalty Upon Early Withdrawal	Not applicable.	Earnings portion of nonqualified withdrawals taxed as ordinary income and subject to federal 10% penalty.	Earnings portion of nonqualified withdrawals taxed as ordinary income and subject to federal 10% penalty.
Gift and GST Consequences	Not subject to gift tax or GST tax.	Subject to gift tax and GST tax; however, the use of the gift tax annual exclusion is permitted.	Subject to gift tax and GST tax; however, the use of the gift tax annual exclusion is permitted.
Estate Tax Consequences	Not included in estate of donor or beneficiary.	Included in beneficiary's estate, but not included in donor's estate.	Included in beneficiary's estate, but not included in donor's estate.
Change of Beneficiary	Not applicable.	Can transfer account penalty-free to benefit member of beneficiary's family.	Can transfer account penalty-free to benefit member of beneficiary's family.
Financial Aid	Not counted as a resource for student or parent.	Pre-paid tuition program - student resource. 529 ESA - included in calculating parental contribution, not a student resource.	Counted as a student resource.