The Quarter Million Dollar Question: Wealth Transfer & College Saving Strategies

By: Michael B. Fischer

For children born this year, the expected cost of attending four years at a public university has reached a staggering $250,000, and that projection continues to rise at a rate of almost twice that of inflation.[1] For many wealthy families, funding a child's or grandchild's college education is among their top financial priorities. When saving for college, most families have heard about "529 Plans" which, if funded at an early age and with frequent contributions, can help make those annual tuition checks more manageable. Although 529 Plans are right for a lot of families, there are situations in which other wealth transfer strategies can be used to fund college expenses while also providing more flexibility and potential long-term wealth transfer benefits. Families may be unfamiliar with these alternative strategies, specifically the Uniform Transfers to Minors Act (UTMA), a 2503(c) Minor's Trust, a Coverdell Education Savings Account, and even a Roth IRA. This article provides an overview of these vehicles, and what factors to consider when determining the appropriate wealth transfer strategy that most appropriately fits your financial goals.

Consider Alternatives

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529 Plans

Section 529 of the Internal Revenue Code (and the birth of "529 Plans") can be traced back to the 1980s when individual states identified a need to bridge the gap between student grants/loans and outright payment of tuition by offering families a tax incentivized way to save money for or to "pre-pay" their children's college educations. 529 Plans (and the federally recognized tax-free growth) became available in the late 1990s and quickly became the go-to choice for many parents looking to save for their children's college education. 529 Plan accounts are established for an individual beneficiary,

[1] From 1993 through 2014, tuition and fees for public 4-year universities rose 110%. The Consumer Price Index ("CPI") has risen 59.7% over the same time period. (CNBC "Why College Costs Are So High And Rising")

usually a child or grandchild, and are funded by gifts of cash to the account. The funds are allocated to a selected investment strategy or fund and grow tax free. Funds can be withdrawn for qualified post-secondary educational expenses, or if the child does not attend college, the account can be used for the educational expenses of a qualifying family member (parents, siblings, cousins, nephews, aunts/uncles). An advantage of a 529 Plan is that assets held in the plan are viewed more favorably when filling out the Free Application for Federal Student Aid ("FASFA") Form to claim financial aid. Assets held in 529 Plans are considered "parents' assets." Colleges assume that 5.64% of parents' assets can be used per year to fund college education, whereas it is assumed that 20% of the dependent child's assets can be used. Factoring a smaller percentage of assets will result in a smaller asset base and can help increase the amount of federal aid a child will receive.

SUPERFUNDING

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Gifts to 529 Plans can be "superfunded" with five times the annual exclusion ($14,000 in 2015) in the first year by making a "5-year election" on a gift tax return.

TAX TREATMENT

Contributions made to 529 Plans are not tax deductible at the federal level; however, the investments in the plan will grow income tax free. The major benefit is that if funds are withdrawn for qualified expenses (which include tuition and fees, room and board, books and supplies, and in some cases, a computer) there is no federal tax and no penalty. Some states even offer tax incentives for their residents. For example, contributions to a New York 529 Plan made by a New York resident (married filing jointly) up to $10,000 per year are deductible on the New York income tax return. An additional tax benefit is that gifts to 529 Plans can be "superfunded" with five times the annual exclusion ($14,000 in 2015) in the first year by making a "5-year election" on a gift tax return. The contribution is treated as if it were made in consecutive years, 2015 through 2019. Superfunding a 529 Plan allows the assets to earn more income and start appreciating earlier than making a gift every year due to the nature of compounding returns. However, no further gifts can be made to the child during the five year period, and the gift may be brought back into the donor's estate on a pro rata basis if he or she passes away during the five years following the initial gift.

INVESTMENTS

A major drawback to 529 Plans is the lack of investment flexibility. Investment choices are limited to a handful of options depending on the provider of the plan. For example, New York State's program is run through Vanguard funds, while New Jersey uses Franklin Templeton. Families have the ability to select which state's plan investment vehicles are best for them, so New York residents who prefer Franklin Templeton funds could use New Jersey's plan; however, doing so would forfeit any tax incentives offered by the state of residence. Investors also do not have the discretion to mix and match mutual funds with ETFs or individual stocks to create a customized allocation. Similarly, investors have the opportunity to rebalance the portfolio two times per calendar year in a 529 Plan. In volatile markets, this may create uneasiness for more conservative families. While this is a drawback for engaged investors, it may be beneficial for those who want to "set it and forget it." Another option is to use age-based investment options, which, at the discretion of the plan, gradually become more conservative as the child reaches college age.

BEST USE AND CONSIDERATIONS

529 Plans are best suited to help parents and grandparents save for post-secondary education by putting away modest amounts over the lifetime of the child. For families with only one child or families that are unsure whether their children will pursue a college education, the inflexibility of a 529 Plan may cause funds to be taxable and subject to a penalty upon distribution if used for non-qualified expenses. A method to mitigate some of the risk of a child not attending college or utilizing scholarships is to only partially fund a 529 Plan and set up a separate investment account in the parent or grandparent's name. If the child does not go to college or receives a large scholarship, the funds in the individual account remain titled in parent or grandparent's name and can be used for a home improvement, an outright gift to the child, or even retirement. The closer to college-age, the less significant the benefit of tax-free growth will be. Thus, if partially funding a 529 Plan, it is beneficial to make those contributions early in the child's life and save after-tax dollars in your own name in later years.

For families that can afford to finance tuition payments directly and want to pass on wealth to their children, the next two strategies provide an alternative to the 529 Plan for making annual exclusion gifts.[2] Transferring wealth and reducing a taxable estate is an important goal for many wealthy families, and by making periodic gifts in addition to financing tuition payments directly, more wealth can be transferred out of an estate.

UNIFORM TRANSFER TO MINORS ACT

The Uniform Transfers to Minors Act (UTMA) is an extension of the Uniform Gift to Minors Act (UGMA) drafted in 1986 as a way to pass assets to minor children. In general, the UTMA allows parents or grandparents to make gifts of money, stock, real estate, fine art, or royalties to a child without the restrictions and costs associated with establishing a trust. The account is set up with a custodian (usually a parent or guardian) until the minor reaches the age of majority (usually 18 or 21 depending on the state) at which time the minor owns the assets outright. This is potentially worrisome as the child will have access to the funds at that age and could make poor decisions. Proper financial education is an important aspect of this wealth transfer strategy. Additionally, although transfers made to a UTMA account are considered completed gifts, if the donor is the custodian and passes away

[2] Transfers made directly to an educational institution to pay educational expenses are not considered gifts for the purposes of the annual gift tax exclusion. IRC §2503(e).

before assets are used or distributed, the account will be included in his or her estate. This potential problem can be avoided by naming a grandparent or another relative as custodian. Like 529 Plans, UTMA accounts need to be established for each individual beneficiary. Unlike 529s, UTMA account assets are considered "children's assets" for financial aid purposes and will negatively impact the eligibility for the child to receive need-based aid.

TAX TREATMENT

One of the unique aspects of UTMA accounts is the treatment of income and capital gains. Because the assets were gifted to this account for the benefit of the minor, in theory, they will be taxed at the income tax brackets of the minor (which would likely be the 10% or 15% bracket). However, due to the potential for avoiding or reducing tax liability by transferring assets to minors in lower tax brackets, the IRS has established "Kiddie Tax" rules. For children under the age of 18 or for full time students under the age of 24 (whose earned income did not exceed one half of the child's own support) the first $2,000 of unearned (investment) income will be taxed at the child's rates, but unearned income in excess of $2,000 will be taxed at the parents' marginal bracket. Because of this issue, contributions to UTMA accounts may be less tax efficient than most 529 Plans.

INVESTMENTS

The investment options in a UTMA account are much broader than in a 529 Plan. A UTMA account can hold almost any type of investment including, cash, mutual funds, publicly traded stocks and bonds, private equity, hedge funds, real estate, private companies (closely held stock) and more. A UTMA is more similar to an individual investment account than a 529 Plan account. Rebalancing is not limited and can happen as frequently or infrequently as the investor chooses. Being tax sensitive in rebalancing is important due to the Kiddie Tax issues mentioned above; therefor, the annual recognition of capital losses or "loss harvesting" should be considered if the portfolio has substantial realized gains.

BEST USE AND CONSIDERATIONS

UTMA accounts are best suited for families that can afford to finance college education during the year of incurred costs, through current income or through accumulated wealth, and would like to pass wealth outright to the next generation. By taking advantage of annual exclusion gifts or one time transfers, a UTMA can accomplish both of these goals. The major opportunity presents itself because tuition payments can be made directly to a university and are excluded from taxable gifts. For example, a parent or grandparent could directly fund college tuition on behalf of the child and make additional gifts of the annual exclusion to a UTMA for the benefit of the child without having to use the lifetime gift and estate exemption. The assets

WEALTH TRANSFER OPPORTUNITY

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held in the UTMA can be used for the child to ultimately save, make a down payment on a home, purchase a vehicle, or for personal travel following graduation. UTMAs allow the custodian to control the assets and invest freely, while passing on wealth to the next generation. However, upon reaching majority, the child is free to access the assets and make his or her own choices. This may be a significant disadvantage for some children.

Similar to UTMA accounts, the next section will detail another wealth transfer strategy for families looking to pass on considerable wealth to the next generation, yet still retain control over the distribution of assets.

SECTION 2503(C) MINOR'S TRUSTS[3]

Section 2503(c) Trusts combine the ability to make annual exclusion gifts to fund education and transfer wealth with the desire to further control or restrict the assets gifted to the child through the terms of a trust. In order for most gifts to qualify for an annual exclusion, they have to be of a *present interest*, meaning that the donee has the immediate right to the use, possession, or enjoyment of the property. Gifts to trusts generally are considered gifts of a *future interest* because the beneficiary cannot access the assets until a specified age or condition is met.[4] The 2503(c) Trust is an exception to the present interest requirement of the annual exclusion gift. 2503(c) Trusts allow annual exclusion gifts to be held within an irrevocable trust for the benefit of a minor, until he or she is 21 years old. At age 21, the minor has the right to request the distribution of these assets as set forth in the trust document. If the window lapses, the assets will continue to be held in trust, possibly providing creditor or spendthrift protection to the beneficiary. Like 529 Plans and UTMA accounts, the 2503(c) Trust can be drafted to allow funds to be used for higher education. Similar to UTMAs, 2503(c) Trusts are not limited to qualified education expenses. For example, the trust assets can be used to rent off campus housing or for groceries at the discretion of the trustee or as detailed in the trust agreement. Similar to UTMAs, assets are considered "children's assets" for financial aid purposes and will negatively impact eligibility for the child to receive need-based aid. For families considering a 2503(c) Trust, financial aid eligibility may not be available regardless due to income or wealth phaseouts.

TAX TREATMENT

The tax treatment for 2503(c) Trusts is similar to other irrevocable trusts in that the income is taxed differently depending on the terms of the trust and whether it remains inside the trust or is distributed to the beneficiary. Income held within a trust and not distributed is taxed at compressed tax rates applicable to trusts, which can be a huge disadvantage for this option. For example, for taxpayers who are married filing jointly, the highest federal tax bracket of 39.6% is reached at $464,850 of income. For income earned within a 2503(c) Trust, the same 39.6% bracket is reached at only $12,300.

[3] IRC §2503(c).

[4] There is an exception to this future interest rule for trusts that allow the beneficiary to withdraw property contributed to the trust within a certain period of time. Crummey v. Commissioner.

However, income earned within the trust and distributed to the child is taxed at the child's marginal tax bracket. This can be beneficial when the child is older than 18 and is not a full time student; however, the "Kiddie Tax" rules that apply to UTMAs also apply to 2503(c) Trusts on income distributed to children younger than 18. If the beneficiary chooses to keep assets in the trust past his 21st birthday, he will be treated as the owner and taxed on the income each year regardless of whether it is distributed because he has constructively received it.[5]

INVESTMENTS

Similar to a UTMA account, a 2503(c) Trust can hold almost any type of investment option, including cash, mutual funds, publically traded stocks or bonds, private equity, hedge funds, real estate, commodities, and more. Additionally, the investor can choose to hold the trust assets in a combination of custodians, mutual fund companies, or banks. There are no limitations on the amount of times the portfolio can be reallocated.

BEST USE AND CONSIDERATIONS

Section 2503(c) Trusts offer a few distinct advantages that make them better for transferring larger amounts of wealth to the next generation. Unlike UTMA accounts, assets placed in this type of trust can benefit from creditor protection and have spendthrift protection capabilities. Unlike 529 Plans, the funds can be, but do not have to be, used for higher education. Additionally, there is flexibility in the type of property gifted to a 2503(c) Trust. Gifts of stock, cash, family limited partnerships (FLPs), closely held businesses, and others can be made. Although there are significant benefits available, the costs associated with 2503(c) Trusts are much higher than UTMAs or 529 Plans and attorney fees for drafting the trust can add up quickly. Additionally, although the grantor's intention may be for the trust to continue past the beneficiary's age of 21, the beneficiary has the opportunity to request a distribution of all trust assets upon reaching 21.

OTHER CONSIDERATIONS

Many investors are familiar with the Roth IRA as a vehicle for tax-free investment growth for retirement needs. Fewer investors are familiar with the Roth IRA as a strategy for college savings. Any individual with earned income can contribute up to $5,500 to a Roth IRA, subject to earned income phase outs (single: $116,000 - $131,000; married filing jointly: $183,000 - $193,000). Distributions can be made from a Roth IRA for qualified education expenses without suffering early withdrawal penalties. Similar to UTMAs and 2503(c) Trusts, the major benefit is the flexibility allowed to use the funds for other purposes, such as retirement. Unlike other options, Roth IRAs have strict contribution limits and income-eligibility phase-outs. However, Roth IRAs (unlike traditional IRAs) do not have age-based required distributions and can grow tax-free.

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[5] Taxpayers are liable for the tax on income, which has not been physically received, but has become available to him or her to draw upon in the future.

Another option for families looking to take advantage of a tax incentive is the Coverdell Education Savings Account (or "ESA"). Coverdell ESA's are available for individuals with modified adjusted gross income less than $110,000 for the year ($220,000 for married filing jointly). A Coverdell ESA can be set up for a beneficiary and funded with up to $2,000 of cash in a given year. This money can be invested in stocks and bonds and will grow tax free until withdrawn to cover qualified education expenses. The major drawback to Coverdell accounts is that it is not a vehicle for funding a college education, but rather an opportunity to save for some anticipated college expenses for a beneficiary. If education expenses continue to increase, the Coverdell ESA should be viewed as a way to fund a portion of tuition, while scholarships, financial aid, or direct expense payment will cover the remainder of expenses.

CONCLUSION

Deciding among college saving and wealth transfer strategies will depend on a number of both economic and non-economic factors. 529 Plans, UTMA Accounts, and Section 2503(c) Trusts all address different methods of college saving and wealth transfer available to families. Issues of taxation, asset control, investment flexibility, and cost should all be considered in developing a family's strategy to meet its individual objectives. If the intent is to fund higher education for children or grandchildren, and you start saving early, the tax-free growth of a 529 Plan is likely the best choice. However, if depleting assets, reducing the gross estate and limiting overall estate taxes is the ultimate objective, taking advantage of the ability to pay tuition directly to the institution and making gifts to a UTMA or 2503(c) Trust passes more wealth to the next generation. It is important to discuss your goals and intentions with your tax and financial advisors before choosing a strategy to help meet your family's educational and wealth transfer objectives.

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