



# The Wealth Counselor

A monthly newsletter for wealth planning professionals

## Understanding Education Savings Vehicles

Volume 4, Issue 5

According to the College Board, the average cost of a four-year college or university is increasing at between two and three times the rate of inflation. For the 2008-2009 school year, total costs average more than \$14,000 per year for an in-state four-year college and \$34,000 per year at a private four-year college.

As a result, saving for college is often the most significant savings goal for adults facing college costs in the future, particularly in light of many clients' depleted portfolio and home values. Thus it is no surprise that advisors who understand all of the options bring significant value to their clients. This issue of The Wealth Counselor examines several alternatives to 529 plans, including their advantages and disadvantages.

### Life Insurance

A cash value whole life or universal life insurance policy generally gives its owner the option of borrowing against the policy's cash value. Flexible premium universal life and variable universal life policies typically include the option to take partial withdrawals of cash value without triggering loan interest charges.

Withdrawals from a cash value life insurance policy (other than a modified endowment contract) are not subject to income tax until the cumulative withdrawals exceed the cost basis, or the aggregate premium payments on the policy. Policy loans from cash value life insurance policies may be used to avoid current income tax on cash distributions in excess of cost basis. Policy owners may therefore take tax-free withdrawals and tax-deferred loans to pay educational expenses (or for any other use), while the cash value build-up continues to grow tax free. If the policy continues until death, the income tax-free death benefit will repay any policy loans and the policy's beneficiaries will receive the remaining net death benefit.

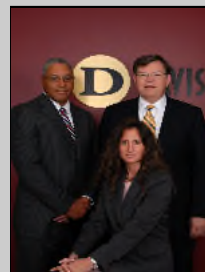
In the event of premature death, the life insurance benefit can complete the planned education funding. The interest rate on policy loans is typically no more than 8% and typically 3/4 or more of each interest payment made is added to the policy's cash value. If the owner chooses not to pay the interest when due, automatic policy loans to pay the interest charge will further reduce the policy's cash value.

From [Francis Brown](#)

### Davis & Associates, P.C.

523 Park Point Drive  
Suite 100  
Golden, CO 80401  
(303) 670-9855

Estate Planning, Business  
Planning and Wealth  
Preservation



**Planning Tip:** Clients should consider the use of flexible, permanent insurance to fund higher education or provide liquidity in the event of a breadwinner parent's premature death.

**Planning Tip:** If owned by an irrevocable trust, life insurance can be free from gift and estate tax yet serve many planning purposes in addition to funding education.

### **Coverdell Education Savings Accounts (ESAs)**

Education Savings Accounts, formerly Education IRAs, were of little significance until passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA made four major changes that made ESAs more attractive and useful:

1. Increased the maximum annual contribution limit from \$500 to \$2,000 per beneficiary;
2. Increased the AGI limits for maximum contributions to these accounts to \$190,000 for a married couple filing jointly and \$95,000 for single taxpayers;
3. Allowed a donor to make contributions to an ESA and a 529 plan for the same beneficiary in the same year; and
4. Allowed ESAs to be used to fund primary and secondary school.

Contributions to an ESA cannot be made after the beneficiary reaches age 18 and the class of possible successor beneficiaries is limited to the beneficiary's immediate family and first cousins.

**Planning Tip:** Clients should consider contributions to both 529 plans and Education Savings Accounts for the same beneficiary in the same year, to cover educational expenses of primary through higher education.

**Planning Tip:** ESAs vary significantly by administrator. It is critical that the advisor carefully review the terms of the particular ESA plan in question.

### **UGMA/UTMA Accounts**

The simplest form of education savings vehicles, and therefore quite common, is an account created under the Uniform Gift to Minors Act (UGMA) or its successor, the Uniform Transfer to Minors Act (UTMA), in the child's state. ***While simple and inexpensive, there are considerable disadvantages to UGMA and UTMA accounts.***

The concern most expressed by clients is that a gift made to an UGMA or UTMA account long ago is about to vest absolutely in a beneficiary who could be damaged by receiving that much money. It is common for neither the custodian nor the donor to have thought about that possibility when the account was established. Only later do they come to understand the consequences of being unable to change the beneficiary and ***the custodian's obligation to deliver the balance of the account outright to the beneficiary when he or she reaches the age of majority*** (18 or 21, as defined by state law). For a beneficiary receiving needs-based government benefits, the required outright distribution

may cause their loss until the UGMA/UTMA funds are gone. For an immature beneficiary, the distribution can cause other problems.

Until the beneficiary reaches majority, the custodian has a fiduciary duty to spend the income or principal for the benefit of the minor. That means that the funds cannot be safely diverted to eliminate or reduce the approaching danger without court approval unless the child consents after reaching age 18.

**Planning Tip:** UGMA and UTMA accounts are the simplest education savings vehicles, but upon attaining the age of majority, the beneficiary has the absolute right to the account and can spend it as he or she pleases, not limited to education.

**Planning Tip:** On learning that your client is contemplating an UTMA gift or that your client is an UGMA/UTMA custodian, immediately discuss the potential problems with the client and alternatives for funding future expenditures for the child's benefit, such as demand trusts (discussed below) and 529 plans.

The "kiddie tax" may also come into play for beneficiaries who are younger than 18 (it previously applied only to beneficiaries younger than 14) or younger than 24 and a student. With the kiddie tax, if the parents claim a child as a dependent and the child is under 18 or under 24 and a student, all of that child's unearned income above \$950 in 2009, including UGMA or UTMA income, will be taxed at the parent's income tax rate, whether or not the parent is the custodian.

**Planning Tip:** The "kiddie tax" applies to UGMA and UTMA accounts if the beneficiary is under 18 (or is a student under 24) and has unearned income greater than \$950 in 2009. If the "kiddie tax" applies, the child must complete and attach IRS Form 8615 to his or her income tax return and pay income tax at the parents' income tax rate.

While a transfer to a minor under UGMA or UTMA constitutes a completed gift for federal gift tax purposes at the time of the transfer, if the donor names himself or herself as custodian of the account and that person dies before the child reaches majority, the UGMA or UTMA account assets will be includible in the donor/custodian's gross estate for estate tax purposes.

**Planning Tip:** A donor should not name himself or herself as custodian of the UGMA or UTMA account to keep the account assets from being included in the donor's estate for federal estate tax purposes.

### **Demand Trusts**

Demand rights convert what would otherwise be a gift of a future interest to a gift of a present interest, thereby qualifying the gift for the \$13,000 gift tax annual exclusion. To qualify, the trustee must adhere to the strict procedure requirements for Crummey trusts: the trustee must notify the minor beneficiary—through the child's legal guardian—that the donor has made a gift to the trust and give the beneficiary the trust-specified period of time (typically 30 days) to demand a distribution from the trust up to the amount of the gift. If the demand right lapses, the gift will stay inside the trust and continue to be governed by the trust terms.

This demand right allows the trust maker to make contributions of up to \$13,000 per year, free of gift tax and possibly generation-skipping transfer (GST) tax.

Demand trusts remove the trust assets from the trust maker's estate, even if the trust maker acts as trustee, as long as the trust instrument limits the trustee's discretion to make distributions to "ascertainable standards"; i.e., the health, education, maintenance and support of the beneficiary (and provided the trust instrument does not give the trust maker too much control over the trust). If a demand right beneficiary dies during the time that a demand right is outstanding, the amount of the outstanding demand right is includible in the beneficiary's gross estate for estate tax purposes.

**Planning Tip:** A demand trust is a flexible savings vehicle for education expenses and other expenses set forth by the trust maker in the trust agreement. While typically funded with life insurance, the trust maker can also fund a demand trust with other assets.

### **Direct Payments to an Educational Institution**

Another educational funding option is for the donor to make transfers directly to an educational institution. Under the Internal Revenue Code, these transfers are not subject to gift, estate, or GST tax. Therefore, prepaid tuition payments by a donor can achieve a significant estate tax reduction. Direct payments are not deductible as a charitable contribution for income tax purposes, however, because they are made for a particular student.

Since only direct payments to the educational institution qualify, it is highly recommended that the donor make contributions to the school while the child is presently enrolled. If the donor wishes to make advance payments for numerous years' tuition, the donor (and the parent(s) if the donor is the student's grandparent) should enter into a written agreement with the educational institution providing that the prepayments are non-refundable. In a 1999 Technical Advice Memorandum, the IRS used as an example a situation where the beneficiary's parent also agreed to pay any tuition and fee increases.

### **HEETs (Health and Education Exclusion Trusts)**

Health and Education Exclusion Trusts are trusts designed specifically to take advantage of the gift tax-free and GST tax-free nature of direct payments to providers for a beneficiary's health and education expenses. With this type of trust, the donor transfers property to a trust carefully drafted to be exempt from GST tax. Oftentimes the donor establishes the trust in a jurisdiction that permits perpetual trusts, because, once exempt from GST tax, the trust can pay direct health and education expenses for grandchildren and their descendants without anyone ever having to pay the onerous GST tax (a tax at the highest federal estate tax rate, currently 45%).

To prevent imposition of GST tax, a HEET must have a charitable beneficiary or beneficiaries with a significant interest that is not separate from the non-charitable beneficiaries' interest.

**Planning Tip:** The charitable beneficiary requirement of the HEET makes it an

unattractive choice for clients who are not charitably inclined or do not have taxable estates and a desire to fund future generations' health and education expenditures.

### Impact on Financial Aid

For many clients, the availability of financial aid plays a role in the planning process, because assets placed in the student's name may reduce (or even eliminate) the amount of otherwise available financial aid. The need-based financial aid rules state that 5% of the parent's assets (special rules determine this amount for financial aid purposes) and 35% of the child's assets are available for education. Therefore, shifting assets from the parent to the student through the use of UGMA/UTMAs, ESAs and 529 plan distributions may reduce the student's need-based financial aid. Alternatively, life insurance should not impact need-based aid, whereas a demand trust will, depending upon the child's access through the trust terms.

**Planning Tip:** Consider strategies that avoid shifting assets to the student to prevent reduction of need-based financial aid.

### Conclusion

There are numerous education savings options. Most often, the "right" choice for the client will depend upon his or her unique goals and objectives. It is therefore incumbent upon the planning team to help the client determine those objectives and advise accordingly.

*To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.*

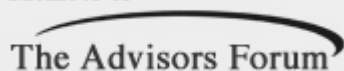
### **For professionals' use only. Not for use with the general public.**

You have received this newsletter because I believe you will find its content valuable, and I hope that it will help you to provide better service to your clients. Please feel free to [contact me](#) if you have any questions about this or any matters relating to estate or wealth planning.

To be removed from this mailing list [unsubscribe here](#).

Davis & Associates, P.C. 523 Park Point Drive Suite 100 Golden, CO 80401 [Website](#)

Member of

The Advisors Forum