ADVISORY MEMORANDUM – Educational Gift Giving to Minors

Summer 2004

I. UNIFORM TRANSFERS TO MINORS ACT ("UTMA")

A. *Massachusetts*

A UTMA account is a custodial savings account for minors. To create a UTMA account, the donor simply transfers property (e.g., cash, stocks, mutual funds, bonds, real property) to a custodian who then manages the account for the minor beneficiary until the age of majority. When the minor reaches 21, the custodianship terminates and the minor becomes the legal owner of the property. There can only be one beneficiary and one custodian per account. The gift is irrevocable and the custodian has full control over the management and investment of the account, subject to a statutory duty to act like a "prudent person dealing with property of another." The custodian also has discretion over when funds are withdrawn. Funds in these accounts do not have to be used for educational purposes, but any withdrawals made prior to the minor turning 21 must be made solely for the minor's use and benefit.

There is no limit on the amount that can be contributed to a UTMA account. A donor can contribute up to $11,000 per year without incurring gift tax liability, and a married donor can give up to $22,000 per year by gift-splitting with his or her spouse. Income derived from the property is taxable to the minor beneficiary. Until age 14, income is taxed at the minor's parent's rate, and after age 14 at the minor's tax rate. However, to the extent income from the account is used to discharge a legal obligation of any person to support the minor, it is taxable to that person to the extent so used.

A bank, trust company, or any adult may act as custodian for a UTMA account. If the minor's parent is named custodian, and dies while serving in that capacity, the value of the account will be included in the parent's gross estate for estate tax purposes. If the parent's estate is such that it is subject to estate taxes, the parent will have to pay tax on the value of the account. Furthermore, if the donor appoints himself or herself as custodian, it will similarly be included in his or her gross estate and possibly subject to estate tax. The donor can avoid this result by naming a spouse or a trusted relative or

friend as custodian, provided that person does not have a legal obligation to support the minor beneficiary. In all circumstances where the custodian is a) not the donor, and b) not someone with a legal duty to support the minor, the assets of the account will only be included in the minor beneficiary's gross estate.

B. *New Hampshire*

The rules and requirements of the New Hampshire Uniform Transfers to Minors Act are substantially identical to the Massachusetts Uniform Transfers to Minors Act.

II. §529 PLAN

There are two types of §529 plans: 1) prepaid tuition plans, and 2) college savings plans.

A. *Prepaid Tuition Plans*

A prepaid tuition plan allows the contributor to purchase vouchers, based on current tuition rates, to be used for the beneficiary's future college expenses. The vouchers can only be used at in-state public institutions of higher education. Thus, these plans are best for people who are fairly certain that the beneficiary will attend an in-state public college. Most plans provide a method for reacquiring the funds if the beneficiary does not attend a participating school, although typically the distribution will be subject to income tax or some other penalty.

B. *College Savings Plans*

What it is – In a college savings plan, the funds are invested in a pre-selected investment portfolio and may be withdrawn at a future date and used for education expenses. These expenses are broadly defined, and include tuition, fees, books, and room and board. There are special rules for off-campus housing, as well as for students attending school less than full-time. While college savings plans do not let the owners lock in current tuition rates and involve a certain amount of investment risk, the funds may be used at any eligible educational institution. Thus, there are no added complexities

if the beneficiary decides to go to a private college or to a college in another state. Most accredited post-secondary educational institutions are eligible.[1]

Investment Control – Account owners can choose among various investment programs and the funds grow tax-free, provided they are ultimately used for higher education expenses. Most states allow owners to change the investment scheme or roll it over to another state's plan, subject to certain time restrictions.

Tax Consequences – A contribution to a college savings plan is treated as a completed gift of a present interest, so it is eligible for the annual gift tax exclusion. An owner may even carry forward a gift in excess of the annual exclusion for up to five years. Thus, in 2004, an owner can donate up to $55,000 without incurring tax liability, and a married couple may double this amount. If the account owner dies before the funds are distributed, the owner's interest is not included in his or her gross estate for federal tax purposes. However, if the owner elects to have a one-time contribution spread over five years, as outlined above, and dies before the five years is up, the amount prorated to the years after death will be brought back into the estate. If the beneficiary dies or becomes disabled such that higher education is no longer an option, the owner can receive a refund with no penalty, but will have to pay income tax on the earnings.

Changing Beneficiaries – An owner can change beneficiaries at any time, although there are adverse tax consequences if the new beneficiary is not a member of the original beneficiary's family or is from a generation two or more levels below the original beneficiary.

Owners – Once an account owner is designated, it usually cannot be changed. However, a successor owner can be designated in case of the death or incompetency of the original owner. Most states' plans only allow one successor owner to be designated, and do not permit any restrictions to be placed on that person's exercise of ownership rights.

Financial Aid – Financial aid applications generally require the applicant to disclose all available assets. The U.S. Department of Education provides that the value of a college savings plan is to be treated as an asset of the owner, not the beneficiary, since the owner can change the beneficiary at any time. Therefore the value of a college

[1] See www.ed.gov/offices/OSFAP/Students/apply/search.html for a complete list.

savings plan will have to be listed on financial aid applications only if the application requires the owner's assets to be listed, i.e. the owner is the applicant's parent. So long as neither the child nor the parents own the plan, its value does not exist for purposes of determining the beneficiary's need for financial aid.

Termination / Withdrawal – A college savings plan can also be terminated, and the funds withdrawn, at any time. Any withdrawal, however, will be assessed a penalty of 10 percent of the withdrawal and will be subject to income tax.

III. CRUMMEY TRUST

The design of a Crummey trust is to remove assets from the donor's estate without incurring gift taxes. Like a UTMA account, the trust can continue until the child reaches 21. Or it can continue to any other age and even continue through the child's lifetime. A Crummey trust can have more than one beneficiary and can be set up to include later-born children. The tremendous flexibility of the Crummey trust is what makes it popular with many individuals.

Generally, the Crummey trust is funded each year with the amount of the gift tax annual exclusion - $11,000 or $22,000 if the donor is married. Because the gift tax annual exclusion is not otherwise available for gifts in trust, each beneficiary must be given a small window of time to withdraw the annual gift. This "withdrawal right" is the distinctive hallmark of a Crummey trust. In fact, "Crummey" is the name of the taxpayer who originated the idea.

A bank, trust company or any natural person can serve as trustee of a Crummey trust. As with custodians of UTMA accounts, however, if the trustee is either the grantor or a person with a legal duty to support the beneficiary, the trust assets will be included in his or her gross estate and may be subject to estate tax.

IV. §2503(c) MINOR'S TRUST

Section 2503(c) of the Internal Revenue Code permits contributions into a certain type of trust to qualify for the annual exclusion, without the necessity of providing for withdrawal rights. A §2503(c) trust, commonly called a "minor's trust," has three simple requirements. First, the terms of the trust must provide that the trustee can distribute

income and/or principal to, or for the benefit of, the minor beneficiary until he/she is 21, with no substantial restrictions being placed on the trustee's ability to so spend. Second, the unexpended trust assets must be capable of being distributed to the beneficiary at 21, at the *beneficiary's* election. Lastly, if the beneficiary dies before attaining 21, the trust assets must either go to his/her estate or pass as the minor directs by his or her will. Furthermore, if a §2503(c) trust is set up for a grandchild or other person more than one generation removed from the donor, contributions up to the annual exclusion amount avoid generation-skipping taxes, as well as gift taxes.

A bank, trust company or any natural person can serve as trustee of a minor's trust. As with custodians of UTMA accounts, however, if the trustee is either the grantor or a person with a legal duty to support the beneficiary, the trust assets will be included in his or her gross estate and may be subject to estate tax.

V. §2503(e) – DIRECT PAYMENT

One of the simplest ways to help with a minor's educational expenses without incurring any adverse tax consequences is through the exception allowed by Section 2503(e) of the Internal Revenue Code. That provision excludes from the gift tax amounts paid directly to an educational organization as tuition on behalf of a student. It is an unlimited exclusion from gift tax for tuition payments, but does not extend to amounts paid for books, supplies, dormitory costs, etc. The payments must be made directly to the educational institution, rather than through the student. The §2503(e) exclusion is available in addition to the annual exclusion and is available regardless of the relationship between the donor and donee.

VI. COMPARISON

	ADVANTAGES	DISADVANTAGES
UTMA	• Flexibility – can use the funds for non-educational purposes if the beneficiary obtains scholarships or decides to forgo post-secondary education • Good for very young beneficiaries • Favorable income tax treatment • Custodian is bound to use funds for minor's benefit	• Donor doesn't have control over management or distributions unless donor is custodian, which has negative estate tax consequences • Custodianship assets must be reported on financial aid forms • Cannot reclaim the funds – gifts are irrevocable • Funds must be distributed to the child when he/she reaches 21 • Can only have one beneficiary per account
529 Plan	• Prepaid tuition plans allow donors to lock in current rates • Donor can control distributions by serving as account owner without incurring estate tax liability • Flexibility – can choose among various investment schemes, some ability to change investments, change beneficiaries, and seek a refund • Most beneficial for very young beneficiaries – tax-free compounding • Will usually not be counted in determining eligibility for financial aid • Favorable income, gift and generation-skipping tax treatment	• Prepaid tuition plans are only beneficial if the minor attends an in-state public school • There's a penalty to reclaim the funds if the minor's plans change • The funds must be used for education • Can only have one beneficiary per account • There are limits on the total size of the account, determined state-by-state
Crummey Trust	• Donor determines the dispositive provisions of the trust, which the trustee must act in accordance with • Can have all children in one trust – can make distributions based on need rather than equality • Can contribute $11,000 for each beneficiary with no gift tax consequences ($22,000 for married donors)	• Donor doesn't have control over management or distributions unless donor is trustee, which has negative estate tax consequences • Beneficiary may decide to exercise his/her withdrawal right and use the funds for a non-approved, non-educational expense • Cannot reclaim the funds – trust is irrevocable
Minor's Trust	• Trustee is bound to use funds for minor's benefit • Flexibility – can use the funds for non-educational purposes if the beneficiary obtains scholarships or decides to forgo post-secondary education, but must be for minor's benefit • Good for very young beneficiaries	• Donor doesn't have control over management or distributions unless donor is trustee, which has negative estate tax consequences • Funds must be distributed or subject to withdrawal by the by the child when he/she reaches 21 • Cannot reclaim the funds • Can only have one child per trust
2503(e)	• Funds are used directly for a stated purpose and cannot be reached by the minor at any time • The §2503(e) exclusion can be used in addition to the annual exclusion, so this is good where there are competing uses of the donor's annual exclusion, such as a life insurance trust	• Not good where there are very young beneficiaries, unless they are enrolled in private primary or pre-school • The exclusion only applies to tuition payments – no flexibility