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Higher Education Savings and Planning: Tax and Nontax Considerations

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ARTICLE
HIGHER EDUCATION
SAVINGS AND PLANNING:
TAX AND NONTAX CONSIDERATIONS

*by: F. Philip Manns Jr. & Timothy M. Todd**

ABSTRACT

Funding higher education is among the critical financial decisions made by individuals and families. There are myriad options. Yet, the conventional wisdom—namely using Section 529 Plans—may not be the optimal vehicle to effectuate this goal. Therefore, this Article discusses various strategies to plan, save, and pay for higher education. It compares various savings methods including gifts, UTMA accounts, Section 529 Plans, trusts, and other vehicles. The analysis explores both tax and non-tax considerations, including the effect of different strategies on financial aid, transaction costs, investor control, income taxes, gift and estate taxes, flexibility, and creditor protection.

This Article concludes that the ubiquitous Section 529 Plan may not be as effective as conventional wisdom suggests. Indeed, we argue that Section 529 Plans are optimal only when capital can be exclusively committed to education funding, which may not be the most desirable savings tactic for a wide swath of American families who need to plan for other financial needs (e.g., retirement and unforeseen medical needs).

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I. INTRODUCTION

Funding higher education is one of the most critical financial decisions individuals and families make. There are myriad options. Yet, the conventional wisdom—namely using Section 529 Plans—may not be the optimal vehicle to effectuate this goal.

According to the National Center for Education Statistics (“NCES”), the “average annual current dollar prices for undergraduate tuition, fees, room, and board were estimated to be \$16,188 at public institutions, \$41,970 at private nonprofit institutions, and \$23,372 at private for-profit institutions.”¹ Over the standard four years of higher education, that amount can exceed \$150,000 (and this does not include, of course, the opportunity cost of attending an institution of higher education). Further compounding the cost of higher education (unfortunately), it has become common for students to take longer than four years to complete their degrees.² Tuition and fees, moreover, generally increase each year. The NCES states that “[b]etween [academic years] 2004–05 and 2014–15, prices for undergraduate tuition, fees, room, and board at public institutions rose 33

1. *Fast Facts*, NAT’L CTR. FOR EDUC. STAT. [hereinafter NCES], <https://nces.ed.gov/FastFacts/display.asp?id=76> [<https://perma.cc/KS7Z-Y8AH>] (using data for the 2014–2015 academic year).

2. The NCES reports that “[t]he median time it took for bachelor’s degree recipients to earn their degree in 2008 was 52 months, according to the Education Department. Forty-four percent of 2007–08 first-time bachelor’s degree recipients completed their degree within 48 months of their initial postsecondary enrollment, another 23 percent within 49–60 months, and an additional 9 percent within 61–72 months.” Tim Weldon, *Reducing Time to Degree by Cutting Credit Creep*, COUNCIL ST. GOV’TS (Aug. 26, 2013, 4:49 PM), <http://knowledgecenter.csg.org/kc/content/reducing-time-degree-cutting-credit-creep#6> [<https://perma.cc/96E5-REL7>].

percent, and prices at private nonprofit institutions rose 26 percent, after adjustment for inflation.”³

Further, the figures describing student loans are simply shocking. Federal Reserve Board data shows that over \$1.4 *trillion* is *presently outstanding* in student loans.⁴ As the NCES reports, “[t]he total annual amount disbursed to students as loans (Direct and Federal Family Education Loans) increased [by 150% (in constant 2011–12 dollars)] . . . from \$43 billion in 2000 to \$109 billion in 2010.”⁵ Indeed, many argue that student loan debt is causing the economy to drag, as repayments hinder the ability to consume, buy houses, or save for retirement.⁶

Consequently, conventional financial planning practice is to exhort parents to save for their children’s higher education. However, the statistics bode poorly for this proposition. For instance, one study found that only two in five families created a plan to pay for college before the student enrolled.⁷ Yet, that same study reported that parental income and savings was the biggest funding source (after scholarships and grants),⁸ and that such parental income savings was used by 59% of families.⁹ And, drilling deeper into those numbers, most of those parental funds are from *current parental income*, not parental savings.¹⁰

3. *Fast Facts*, *supra* note 1. Bucking that trend, though, “[t]he price for undergraduate tuition, fees, room, and board at private for-profit institutions decreased 18 percent between 2004–05 and 2014–15, after adjustment for inflation.” *Id.*

4. *Consumer Credit - G.19*, FED. RES. BOARD, <https://www.federalreserve.gov/releases/G19/Current/> [<https://perma.cc/L9TA-4R3Q>] (data reflects April 2017 figures).

5. *Financing Postsecondary Education in the United States*, NCES, https://nces.ed.gov/programs/coe/indicator_tua.asp [<https://perma.cc/QKJ5-65E7>] (last updated May 2013).

6. *See, e.g.*, Suze Orman, *Biggest Economic Threat? Student Loan Debt*, USA TODAY (Oct. 25, 2014, 6:06 AM), <https://www.usatoday.com/story/money/personal-finance/2014/10/25/student-loan-debt/17773131/> [<https://perma.cc/T3G3-TYVU>]; Dan Kadlec, *Student Loans Are Becoming a Drag on the US Economy*, TIME (Oct. 18, 2013), <http://business.time.com/2013/10/18/student-loan-are-becoming-a-drag-on-the-us-economy/> [<https://perma.cc/WF6N-HP3M>]; Kelley Holland, *The High Economic and Social Costs of Student Loan Debt*, CNBC (June 15, 2015), <http://www.cnbc.com/2015/06/15/the-high-economic-and-social-costs-of-student-loan-debt.html> [<https://perma.cc/6YFB-3WGZ>]; Mitchell E. Daniels, *How Student Debt Harms the Economy*, WALL ST. J. (Jan. 27, 2015, 6:34 PM), <https://www.wsj.com/articles/mitchell-e-daniels-how-student-debt-harms-the-economy-1422401693> [<https://perma.cc/VU8Z-86GS>]; Josh Mitchell, *Federal Student Lending Swells*, WALL ST. J. (Nov. 28, 2012, 11:48 AM), <https://www.wsj.com/articles/SB10001424127887324469304578145092893766844> [<https://perma.cc/ME7Q-N3PZ>].

7. *How America Pays for College 2016*, SALLIE MAE 8 (2016), http://news.sallie-mae.com/files/doc_library/file/HowAmericaPaysforCollege2016FNL.pdf [<https://perma.cc/T87E-F7DW>].

8. *Id.* at 11.

9. *Id.*

10. *Id.* at 13.

To incentivize college savings, Congress enacted “Section 529 Plans” that allow funds to grow tax free when used for qualified higher education savings.¹¹ Surprisingly, despite this tax benefit, less than 3% of families participated in Section 529 Plans or Coverdell Education Savings Accounts, according to a Government Accountability Office report.¹² That same report notes that the following factors inhibit the use of Section 529 Plans: (1) not having enough resources to save; (2) underestimating the cost of college; (3) not being familiar with Section 529 Plans; and (4) having problems selecting or using a Section 529 Plan.¹³ Empirical evidence also indicates that higher-income households are more likely to use Section 529 Plans.¹⁴

After reviewing the education savings options, we conclude that there is a singularly paramount planning framework. Does the client have capital that she: (1) can commit exclusively to the higher education of the children; (2) can commit exclusively to the children; or (3) must the capital be available for other family uses with an expectation that it can be used for the higher education of the children? The answer to this question, as we will explain, is the key point in the education savings analysis.

This Article proceeds in three main parts. First, we provide an overview of the relevant factors to consider while planning for higher education expenses. Second, we analyze the popular savings vehicles vis-à-vis those factors. Third, we synthesize these options into three paradigmatic planning options that should serve as the default planning position for various levels of household wealth.

II. THE RELEVANT FACTORS

We identify and analyze eight relevant factors to consider in an education savings analysis: (1) contribution limits, (2) financial aid consequences, (3) income taxation, (4) gift taxation, (5) estate taxation, (6) generation-skipping transfer taxation, (7) creditor protection, and (8) use and flexibility considerations. There may be, of course, other relevant factors depending on the particular facts and circumstances.

11. See I.R.C. § 529 (2012); see also *infra* Section VIII (discussing Section 529 Plans).

12. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-64, HIGHER EDUCATION: A SMALL PERCENTAGE OF FAMILIES SAVE IN 529 PLANS 14 (2012), available at <http://www.gao.gov/assets/660/650759.pdf> [<https://perma.cc/V4J4-ZDNM>] [hereinafter GAO REPORT ON 529 PLANS]. But, the Sallie Mae study indicates the Section 529 Plan utilization rate may be as high as 16 percent. See *How America Pays for College 2016*, *supra* note 7, at 13.

13. GAO REPORT ON 529 PLANS, *supra* note 12, at 26–31.

14. See *An Analysis of Section 529 College Savings and Prepaid Tuition Plans*, TREASURY DEP'T 3 (Sept. 9, 2009), <https://www.treasury.gov/resource-center/economic-policy/Documents/09092009TreasuryReportSection529.pdf> [<https://perma.cc/4RH6-865U>] [hereinafter *Treasury Report*].

A. Contribution Limits

Some higher education savings vehicles are tax-preferred vehicles, meaning that either current income or growth on capital may be excluded (or deferred) from taxation at the federal or state levels.¹⁵ To curb potential abuses, Congress limits the amount that can be contributed to the plan.¹⁶ Similarly, states create contribution limits either by placing express limits on account vehicles or by placing a limit on the available tax deduction, which also serves as a practical cap on contributions.¹⁷

Therefore, when choosing a funding strategy, contribution limits need to be considered. This may be particularly true when the family experiences a sudden financial windfall (e.g., an inheritance) that needs to be invested or otherwise deployed. Continuing this example, minimizing the tax consequences of the windfall, as well as meeting a noble parental pursuit—such as education funding—is an important financial planning consideration; but, depending on the vehicle, the entire windfall may not be able to be contributed at the same time.

B. Financial Aid

The federal government provides extensive financial aid for students attending institutions of higher education.¹⁸ The amount of federal aid made available to a student is based upon the student's statutorily defined *need*.¹⁹ The amount of *need* is equal to: (1) the *cost of attendance* minus (2) the *expected family contribution* minus (3) non-federal financial assistance.²⁰ The *cost of attendance* is determined by the educational institution and includes tuition, fees, books, and living expenses.²¹

Of the three elements comprising the *need* calculation—*cost of attendance*, *expected family contribution*, and non-federal financial assistance—the family only has substantial control over the expected family contribution. The cost of attendance is determined by the institution, and the non-federal financial aid is determined by other providers of aid, such as scholarship providers. Thus, proper financial aid

15. *E.g.*, I.R.C. § 529(a) (providing that “[a] qualified tuition program shall be exempt from taxation under this subtitle”).

16. *See, e.g.*, *Treasury Report*, *supra* note 14, at 2.

17. *See, e.g.*, VA. CODE ANN. § 58.1-322.03(7)(a) (West 2017).

18. For example, in terms of financial aid generally (i.e., not just federal aid), the NCES reports that “[s]tudents at private nonprofit 4-year institutions received an average of \$20,100 in grant and scholarship aid, compared with \$7,100 at public and \$5,200 at private for-profit 4-year institutions.” *Price of Attending an Undergraduate Institution*, NCES, https://nces.ed.gov/programs/coe/indicator_cua.asp [<https://perma.cc/Y5BB-5UGF>] (last updated Apr. 2017).

19. The so-called “Need Analysis” rules are codified at 20 U.S.C. §§ 1087kk–1087vv (2012).

20. *Id.* § 1087kk.

21. *Id.* § 1087ll.

planning involves examining the effect of various savings strategies on computing the *expected family contribution*.

For a dependent student, the *expected family contribution* equals the sum of three elements: (1) the *parents' contribution from adjusted available income*; (2) the *student contribution from available income*; and (3) the *student contribution from assets*.²² The statutory nomenclature reflected in the previous sentence is potentially confusing because it suggests that parents contribute from income, while students contribute from both income and assets. However, the *parents' contribution from adjusted available income* includes a *parents' contribution from assets*.²³ Thus, both the parents and the dependent student contribute to the *expected family contribution* from both income and assets, but at significantly different rates for assets.

The *parents' contribution from adjusted available income* is the sum of two elements: (1) *parents' available income* and (2) *parents' contribution from assets*.²⁴ This sum is then multiplied by an assessment percentage, which is 47% for incomes above \$32,300.²⁵

Parents' available income in a typical situation is: (1) adjusted gross income for federal income tax purposes plus (2) employee (but not employer) contributions to retirement plans minus (3) taxes on income (federal, state, and Social Security).²⁶ *Parents' contribution from assets* in a typical situation is 12%²⁷ of the aggregate value of assets,²⁸

22. *Id.* § 1087oo(a)(1)–(3).

23. *Id.* § 1087oo(b)(1)(B).

24. *Id.* § 1087oo(b)(1).

25. Federal Need Analysis Methodology for the 2017–18 Award Year, 81 Fed. Reg. 52,418, 52,422 (Aug. 8, 2016). The assessment of the *parents' adjusted available income* is \$8,728 plus 47% of *adjusted available income* over \$32,300. *Id.*

26. “Available income” for both parents and students is “total income” less exclusions. 20 U.S.C. § 1087oo(c), (g). “Total income” is “adjusted gross income” plus “untaxed income and benefits.” *Id.* § 1087vv(a). “Untaxed income and benefits” includes, among others, “untaxed portion of pensions;” contributions to pension plans, when such contributions are excluded from taxable income; and contributions to health savings accounts. *Id.* § 1087vv(b); U.S. DEP’T OF EDUC., FEDERAL STUDENT AID HANDBOOK: 2016–2017 AVG-21 (2016) [hereinafter 2016 FSA HB], available at <https://ifap.ed.gov/fsahandbook/attachments/1617FSAHBkActiveIndexMaster.pdf> [<https://perma.cc/6C3J-9XWL>]. Not included in “untaxed income and benefits” are employer retirement contributions, *id.* at AVG-21; employer contributions to employee health benefits, 2016–2017 FASFA form line 94; and flexible spending arrangement contributions, 2016 FSA HB at AVG-23.

27. 20 U.S.C. § 1087oo(d)(4).

28. The statutory nomenclature for asset, investment, and net worth is inconsistent. The “parental net worth” includes the “net value of investments.” 20 U.S.C. § 1087oo(d)(2)(B). “Net value of investments” is used three times, but never defined. *Id.* §§ 1087oo(d)(2)(b), 1087pp(c)(2)(B), 1087qq(c)(2)(B). The definitional section of the relevant part, section 1087vv, does not define “investment,” but does define “assets” and “net assets.” *Id.* § 1087vv(f), (g). “Assets” means the “amount” of things typically thought to be investments plus the “net value of real estate” (excluding principal residences and farms). *Id.* § 1087vv(f). “Net assets” means “the current market value at the time of application of the assets (as defined in subsection (f) of this section), minus the outstanding liabilities or indebtedness against the assets.” *Id.*

excluding principal residences²⁹ and retirement plans,³⁰ but including Section 529 Plans owned by either of the parents or by the student, minus only debt that is secured by any such included assets.³¹ Thus, each year, for parents' assets, 5.64%³² of the aggregate value is included in the expected family contribution, and for parents' income, each year 47% is included in the expected family contribution. The student contribution from available income is 50%.³³ Therefore, in determining the expected family contribution, it makes little difference whether income is earned by the parents or student.³⁴ Not so for assets. The student contribution from assets is a flat 20% without regard to income.³⁵ Thus, student-owned assets contribute to expected family contribution at a rate of about four times greater than parent-owned assets (20% versus 5.64%). Consequently, when structuring plans for

§ 1087vv(g). The FSA Handbook states that an "asset is property that the family owns and has an exchange value." U.S. DEP'T OF EDUC., FEDERAL STUDENT AID HANDBOOK: 2017-2018 AVG-16 (2017) [hereinafter 2017 FSA HB], available at <https://ifap.ed.gov/fsahandbook/attachments/1718FSAHbkActiveIndex.pdf> [<https://perma.cc/3QXT-NYL2>]. It then states that "[m]ost assets are investments," provides a non-exhaustive list of assets (different from the statutory list in section 1087vv(f)), and states, "The FAFSA asks for the net worth of investments, which is their total current market value minus their associated debts." *Id.*

29. 20 U.S.C. § 1087vv(f)(2).

30. 2016 FSA HB, *supra* note 26, at AVG-17. The statute does not exclude retirement plans from the statutory terms "parental net worth," "net value of investments," or "net assets," but exists entirely from administrative decision.

31. 20 U.S.C. § 1087vv(g).

32. The 5.64% is calculated by multiplying 0.12 (parents' contribution from assets) by 0.47 (assessment percentage).

33. 20 U.S.C. § 1087oo(g)(5). Family farms and family businesses are excluded also, but not thought to arise in the typical situation. Retirement plans include 401(k)s, pension funds, annuities, non-education IRAs, Keogh plans, and whole life insurance. 2016 FSA HB, *supra* note 26, at AVG-17.

34. At low income levels, the parents' higher income exemption levels become relevant, thus a planning preference exists for parent income at low income levels. Student income has these allowances: federal income tax paid; state and other tax allowance (Table A7); Social Security tax allowance (Table A2); and income protection allowance (\$6,420 for 2017-2018). *Id.* at AVG-50 (allowances against student income). Table A7 rates are between 0% (Alaska) and 6% (New York) with most at 1-3%. *Id.* at AVG-60. Table A2 rates repeat true employee Federal Insurance Contributions Act ("FICA") liability: 7.65% up to annual maximum, then 1.45%. *Id.* at AVG-58; *see also* 20 U.S.C. § 1087oo(c)(1).

Parent income allowances are higher. Included are federal income tax paid; state and other tax allowance (Table A1, having two bands, \$0 to \$15,000 and above \$15,000; rates are between 1% and 10%); Social Security tax allowance (Table A2); income protection allowance (Table A3) (dependent upon income, number of college students and number in household, and ranging from \$15,000 to \$38,000); and employment expense allowance (maximum \$4,000). 2016 FSA HB at AVG-49; 20 U.S.C. § 1087oo(g)(1).

In addition, for parental contributions, an "education savings and asset protection allowance" is available as a subtraction to parents' net worth, between \$0 and \$32,000, depending on number of parents and the age of oldest parent. Federal Need Analysis Methodology for the 2017-18 Award Year, 81 Fed. Reg. 52,418, 52,420 (Aug. 8, 2016).

35. 20 U.S.C. § 1087oo(a)(3), (h).

higher education savings, financial aid considerations make parent ownership of assets significantly preferable to student ownership.

C. *Income Taxation*

Gross income includes income from whatever source derived.³⁶ Nevertheless, to effectuate favorable public policy, Congress provides preferential tax treatment to various types of income or behavior.³⁷ The income taxation of savings and its growth—whether education savings or otherwise—can drastically reduce the funds available for ultimate use.³⁸ In a savings vehicle analysis, three phases need to be considered: (1) the income taxation of the initial capital; (2) the income taxation of that capital’s growth or earnings; and (3) the income taxation of withdrawals from that capital. An analogous analysis exists for IRAs and other qualified retirement plans; that is, qualified plans differ (and strategy comes into play) on the taxation of the three phases.

D. *Gift Taxation*

Federal gift tax is levied on “the transfer of property by gift . . . by any individual.”³⁹ Therefore, transfers by an individual to enable another to attend an institution of higher learning are gifts. However, in computing gift tax liability, substantial exclusions exist for transfers for educational expenses.⁴⁰ Because such exclusions are specific to the particular savings method chosen, discussion of them will occur in the technique-by-technique analysis section.

E. *Estate Taxation*

Federal estate tax is levied on “the transfer of the *taxable estate* of every decedent who is a citizen or resident of the United States.”⁴¹ The value of the taxable estate is equal to the value of the gross estate

36. I.R.C. § 61(a) (2012).

37. For example, in this context specifically, there are myriad tax breaks that cut against broad tax concepts, such as the tax deduction for higher education expenses. Higher education expenses are prototypical personal expenses and—but for a specific policy decision by Congress—would be non-deductible. See I.R.C. § 262; see also Treas. Reg. § 1.162-5(a)(2)(i) (as amended by T.D. 6918, 32 Fed. Reg. 6679) (“expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business” are not deductible). However, “the code contains at least 19 tax incentives to encourage college attendance.” Jay Starkman, *Why Are Taxes So Complex?*, 156 TAX NOTES 1255 (Sept. 4, 2017) (citing Joint Committee on Taxation, *Background and Present Law Related to Tax Benefits for Education*, JCX-70-14 (June 20, 2014), available at <https://perma.cc/G27N-6U8U>).

38. That is, if the funds are needed to satisfy income tax obligations.

39. I.R.C. § 2501(a)(1).

40. I.R.C. §§ 529(c)(2), 2503(c), 2503(e).

41. *Id.* § 2001(a) (emphasis added).

minus certain deductions.⁴² “The value of the gross estate of the decedent . . . includ[es] . . . the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.”⁴³ Thus, any property existing under various educational savings methods can become part of the gross estate of a decedent who dies before that property has been consumed in the payment of educational expenses. Because the gross-estate-inclusion rules are specific to the particular savings method chosen, discussion of the inclusion will occur in the technique-by-technique analysis section.

F. *Generation-Skipping Transfer Taxation*

A generation-skipping transfer tax (“GST tax”) is imposed “on every generation-skipping transfer”⁴⁴ There are three types of *generation-skipping transfers*.⁴⁵ Most relevant for educational savings is the *direct skip*, defined as a transfer that is simultaneously (i) subject to either the gift tax or estate tax and (ii) made to a *skip person*.⁴⁶ The archetypal *skip person* is a grandchild of the transferor, but the definition is broader and includes “a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor”⁴⁷ Because grandparents often contribute to higher-education savings plans for their grandchildren, GST tax consequences must be analyzed. Because the GST rules are specific to the particular savings method chosen, discussion of the GST tax consequences will occur in the technique-by-technique analysis section.

G. *Creditor Protection*

Another important consideration—and one typically overlooked—is the creditor protection that is available to a savings vehicle. Again, to effectuate the pursuit of higher education—and, perhaps, to affect behavior, of course—federal⁴⁸ and state governments often provide protections barring creditors from seizing funds dedicated to higher-education expenses.⁴⁹ However, not all higher-education savings vehicles offer the same creditor protection (some offer none!); this is very state specific—even with the same savings vehicle (e.g., some states grant different protections to Section 529 Plans). Therefore, we will

42. *Id.* § 2051.

43. *Id.* § 2031(a).

44. *Id.* § 2601.

45. *Id.* § 2611(a) (“[T]he term ‘generation-skipping transfer’ means . . . (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.”).

46. *Id.* § 2612(c).

47. *Id.* § 2613(a)(1).

48. See 11 U.S.C. § 541(b)(6) (2012) (generally removing, with some exceptions, Section 529 assets from property of the bankruptcy estate).

49. See, e.g., VA. CODE ANN. § 23.1-707(F) (West 2016); TEX. PROP. CODE ANN. § 42.0022(a) (West 2003); FLA. STAT. ANN. § 222.22(1) (West 2015).

analyze the creditor protection typically afforded to the common savings options.

H. Use

The above benefits—e.g., favorable tax treatment and creditor protection—normally come at a cost: restrictions on the use of the funds. The main restriction is that the funds have to be used for higher education expenses. Surprisingly, as we will discuss, that definition is not consistent. Moreover, it may be the case that the benefits are not worth the restrictions placed on the funds. In other words, fund flexibility may serve other valuable familial pursuits—or at least keep those options open—such as retirement funding.

III. THE TECHNIQUES

The Authors have identified six commonly used savings vehicles to fund higher education expenses. Those techniques include the following: (1) Pure savings, (2) UTMA transfers, (3) Section 2503(c) trust transfers, (4) *Crummey* trusts, (5) Section 529 Plans, and (6) Coverdell Education Savings Accounts (“ESA”). We now analyze these savings vehicles.

IV. PURE SAVINGS

Pure savings means savings by the parents in which one or both parents own the funds; therefore, none of the educational savings preferences are utilized. This is the base scenario against which the other educational savings techniques will be measured.

A. Income Taxation

In a “pure savings” method, one or both parents own the funds, and they consequently bear the burden of income tax on all income earned and gain realized upon sale.⁵⁰ However, strategies exist to mitigate income tax liability. First, preferential capital gains rates apply to gain realized upon sale of nearly all passive investments.⁵¹ In addition, those preferential capital gains rates also apply to the income arising from investments that pay dividends.⁵² Second, tax efficient funds exist to limit the amount of current income, which accomplishes the timing benefit of deferring the payment of tax.⁵³ Third, a parent can transfer the investment to the child prior to sale, which the child could

50. I.R.C. § 61(a)(3)–(7).

51. *See id.* § 1(h) (providing preferential tax treatment for “net capital gain”).

52. *See id.* § 1(h)(11) (including “qualified dividend income” as part of net capital gain).

53. “Tax efficient funds” are funds that are managed in such a manner to minimize—to the extent possible—the taxation of the fund.

then report the income at his or her lower rates of income tax, subject only to the kiddie tax.⁵⁴

B. *Financial Aid*

As a parent asset, in a “pure savings” strategy, the asset’s value would enter the *expected family contribution* as a *parents’ contribution from assets*; which, as noted earlier, is 5.64% of the value per year.⁵⁵ By contrast, a parent’s payment of a dependent student’s college costs is not included in the *total income* of the student for financial aid purposes.⁵⁶ Thus, for pure savings, only a small portion (5.64%) of the value of the savings enters the expected family contribution, and any distributions from those savings for higher education expenses do not.

C. *Gift Tax*

Federal gift tax is levied on “the transfer of property by gift . . . by any individual”⁵⁷ However, two important exclusions are available. First, an annual exclusion exists by which the first \$14,000⁵⁸ of gifts by a donor to any person or persons during the calendar year shall not “be included in the total amount of gifts made during such year.”⁵⁹

Second, a specific exclusion exists for “any amount paid on behalf of an individual . . . as tuition to an educational organization . . . for the education or training of such individual”⁶⁰ The limits that the Treasury Regulations have placed on *tuition* amplify three points: (1) the tuition exclusion is unlimited;⁶¹ (2) the payment must be made directly to the educational institution;⁶² and (3) *tuition* is narrowly construed.⁶³ As the Treasury Regulations provide: “The unlimited exclusion is permitted for tuition expenses of full-time or part-time students paid directly to the qualifying educational organization

54. Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 710, § 3.02 (“For taxable years beginning in 2017, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child’s return that is subject to the ‘kiddie tax,’ is \$1,050. This \$1,050 amount is the same as the amount provided in § 63(c)(5)(A), as adjusted for inflation. The same \$1,050 amount is used for purposes of § 1(g)(7) (that is, to determine whether a parent may elect to include a child’s gross income in the parent’s gross income and to calculate the ‘kiddie tax.’”).

55. 20 U.S.C. § 108700(d)–(e).

56. 2016 FSA HB, *supra* note 26, at AVG-22.

57. I.R.C. § 2501(a)(1) (levying the gift tax).

58. This amount is adjusted for inflation. *See id.* § 2503(b)(2); *see also* Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 714, § 3.37(1) (“For calendar year 2017, the first \$14,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under § 2503 made during that year.”).

59. I.R.C. § 2503(b)(1).

60. *Id.* § 2503(e)(2)(A).

61. *Id.* § 2503(e).

62. *Id.* § 2503(e)(2).

63. Treas. Reg. § 25.2503-6(b)(2) (1984).

providing the education. No unlimited exclusion is permitted for amounts paid for books, supplies, dormitory fees, board, or other similar expenses which do not constitute direct tuition costs.”⁶⁴

Consequently, under a “pure savings” strategy, the payment of higher educational expenses has gift tax consequences, but they are substantially mitigated by exclusions. As long as tuition⁶⁵ is paid directly to the educational institution, it is not a taxable gift. Payments of fees, room, board, books, and supplies are not within the educational exclusion. However, such payments would fall within the annual exclusion, which is currently \$14,000, per donor per donee per year. Thus, if the student has two living parents, each can use an annual exclusion, providing cover for \$28,000 in annual gifts.⁶⁶ If the non-tuition expenses exceed the annual exclusion, then the donor(s) would have to file gift tax returns and consume some of the lifetime exclusion.⁶⁷

D. Estate Tax

In a “pure savings” strategy, the parents make investments in which one or both parents own the property. If one parent owned the property and dies, the value of such property is included in the decedent’s federal gross estate.⁶⁸ If the parents owned the property jointly and were married when one died, with the survivor being a U.S. citizen, then the decedent’s federal gross estate would include one-half of the value of the property.⁶⁹ If the parents owned the property jointly and were not married, or were married but the survivor is not a U.S. citizen,⁷⁰ then the decedent’s federal gross estate would include the value of the property proportionate to her contributions.⁷¹ Conversely, if the student for whom the savings were being made died, no estate tax inclusion would occur because the student did not own the property,⁷² i.e., it was owned by her parents.

64. *Id.*

65. The section 2503(e) exclusion extends only to “tuition.” I.R.C. § 2503(e)(2)(A). Tuition is not defined in the statute. The regulations state things that are not tuition: “No unlimited exclusion is permitted for amounts paid for books, supplies, dormitory fees, board, or other similar expenses which do not constitute direct tuition costs.” Treas. Reg. § 25.2503-6(b)(2).

66. This is known as “gift splitting” and is expressly allowed by I.R.C. § 2513.

67. In addition, a taxpayer could investigate whether the payment of higher education expenses is not a gift, but in satisfaction of the parent’s legal duty of support to the child.

68. *Id.* § 2033.

69. *Id.* §§ 2040(b)(1), 2056(d)(1)(B).

70. *Id.* § 2056(d).

71. *Id.* § 2040(a).

72. *Id.* § 2033.

E. *GST Tax*

Most relevant to higher education savings plans is the *direct skip*, which is defined as a transfer that is simultaneously (i) subject to either the gift or estate tax and (ii) made to a *skip person*.⁷³ The archetypal *skip person* is a grandchild of the transferor. Consequently, if a grandparent uses a “pure savings” strategy to pay higher-education expenses for her grandchildren, a direct skip occurs. However, just as exclusions exist for gift taxes, similar—but not identical—exclusions exist for the GST tax.⁷⁴ Most prominently for “pure savings” plans, section 2642(c) exempts “certain direct skips which are nontaxable gifts.”⁷⁵ Such are defined as “any transfer of property to the extent such transfer is not treated as a taxable gift by reason of . . . section 2503(b) [annual exclusion] . . . or section 2503(e) [medical/educational exclusion].”⁷⁶ Therefore, so long as either of those gift tax exclusions (section 2503(b) or (e)) applies to a grandparent’s payments of higher education expenses, GST tax liability would not arise. However, were the payments to exceed those gift tax exclusions, then both gift and GST tax liability would arise, even though both would likely be covered by substantial lifetime exclusions.⁷⁷

73. *Id.* § 2612.

74. Here is an example of how the gift and GST taxes are not coterminous. A transfer to a discretionary trust that provides a time-limited general power of appointment to a beneficiary qualifies for the gift tax annual exclusion under section 2503(b). *Crummey v. Comm’r*, 397 F.2d 82 (9th Cir. 1968). However, such transfers do not qualify as “direct skip nontaxable gifts” under the GST because, during the life of power-holder, trust property attributable to that lapsed power could be distributed, under the discretionary power of the trustee, to someone other than the power-holder. I.R.C. § 2642(c)(2)(A).

75. *Id.* § 2642(c).

76. *Id.* § 2642(c)(3).

77. In general terms, for the three federal transfer taxes—gift, estate, and GST—every taxpayer has an exclusion amount of \$5.49 million for 2017. *Id.* § 2010(c)(3) (creating a “basic exclusion amount” of \$5 million for the estate of every decedent and indexing that amount for inflation); Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 714, § 3.35 (“For an estate of any decedent dying in calendar year 2017, the basic exclusion amount is \$5,490,000 for determining the amount of the unified credit against estate tax under § 2010.”); I.R.C. § 2505(a) (creating a “[u]nified credit against gift tax” equal to the “applicable credit amount” for the estate tax as would apply if the donor died as of the end of the calendar year); *id.* § 2631(c) (creating a “GST exemption amount” equal to the “basic exclusion amount under section 2010(c)”). However, the estate tax exclusion is net of the gift tax exclusion. *Id.* § 2001(b)(1). Thus, a taxpayer’s exemption can be applied against taxable gifts or against the taxable estate, but not both. However, the exclusion for gift or estate taxes is increased by the amount of any unused exclusion of the taxpayer’s “last deceased spouse.” *Id.* § 2010(c)(4) (defining “[d]eceased spousal unused exclusion amount”). But, a taxpayer’s GST exemption amount is not increased by any unused GST exemption of her last deceased spouse. *Id.* § 2631(c) (limiting GST exemption to the “basic exclusion amount under section 2010(c)”).

F. *Creditor Protection*

Creditor protection is of grave concern here. Without planning, pure savings funds are general assets of the owner (student, parent, or grandparent) and can be seized as such. That is, because the funds are not dedicated for education or other preferred expenditure, the law does not protect them as it protects dedicated education funds. However, the creditor exposure can be minimized by general asset protection planning. For example, in states that allow it, holding pure savings funds in tenants-by-entirety accounts can increase protection because now both the husband and wife would need to be liable to the creditor.⁷⁸ Although far from bulletproof, tenants by entirety offers more protection than solely owning the property or owning the property as tenants in common, everything else being equal. For parents who are not married, the options are minimal, but may include generic exemptions, which are incredibly state specific.⁷⁹ Furthermore, to reduce the likelihood of a creditor trying to seize savings funds, parents should undergo a comprehensive insurance analysis to ensure that adequate protections (i.e., third-party payment sources) are in place.⁸⁰

G. *Use*

A primary advantage of the “pure savings” educational savings method is that no limits exist on the use of funds, as sometimes exist for other methods. Pure savings capital is not committed exclusively to the higher education of the children or even exclusively to the children, but remains available for other family uses. Importantly, then, these funds can be used for other contingencies if the need arises, such as unforeseen medical expenses and the like.

H. *Changes in Beneficiary*

Another advantage of the “pure savings” method is that no limits exist on whom the beneficiary can be, as sometimes exist for other methods; that is, the funds are not exclusively dedicated to a particular individual or purpose. Thus, saved capital can be used for the higher education of more than one child, without the need to designate which child is the beneficiary of the savings when the savings are initially made.

78. See, e.g., VA. CODE ANN. § 55-20.2(A) (West 2017) (“Any husband and wife may own real or personal property as tenants by the entireties.”).

79. For example, compare Virginia’s paltry \$5,000 homestead exemption (or \$10,000 if older than 65), VA. CODE ANN. § 34-4 (West 2016), with Florida’s unlimited (with some restrictions) exemption, FLA. CONST. art. X, § 4 (West 1968).

80. For example, examining limits on automobile and homeowner (or renter) policies; considering uninsured and underinsured motorist coverage; and purchasing an umbrella liability policy.

I. *Other*

In the “pure savings” strategy, education credits and deductions are available that are not available when other strategies are used. They include the American Opportunity Tax Credit (Hope Scholarship Credit),⁸¹ the Lifetime Learning Credit,⁸² and the tuition-and-fees deduction.⁸³ These income tax benefits reduce the net cost of having to include in taxable income either periodic income or sale gains.

V. UTMA TRANSFERS

The Uniform Transfers to Minors Act⁸⁴ (“UTMA”) creates an ownership regime for *custodial property* that is created when (i) a transfer is made and (ii) the property is registered “in the name of the transferor, an adult other than the transferor, or a trust company, followed in substance by the words: ‘as custodian for _____’ (name of minor) under the [Name of Enacting State] Uniform Transfers to Minors Act”⁸⁵ Consequently, to create a UTMA account, the transferor must satisfy the formalities of the UTMA statute. Failure to do so typically will result in the creation of a trust, because a trust is the default legal mechanism for transfers from one person to a second person for the benefit of a third person if the requisite formalities are not satisfied to create some other form.⁸⁶

81. I.R.C. § 25A(a)(1), (b); *see generally American Opportunity Tax Credit*, IRS, <https://www.irs.gov/individuals/aotc> [<https://perma.cc/67SU-FVK5>] (last updated Aug. 3, 2017).

82. I.R.C. § 25A(a)(2), (c); *see generally Lifetime Learning Credit*, IRS, <https://www.irs.gov/individuals/lc> [<https://perma.cc/KSW3-ND9X>] (last updated Aug. 11, 2017).

83. I.R.C. § 222; *see generally Tuition and Fees Deduction*, IRS, <https://www.irs.gov/credits-deductions/individuals/tuition-and-fees-deduction-at-a-glance> (last updated Mar. 5, 2018). However, the “Tax Cuts and Jobs Act,” Pub. L. 115-97, and the Bipartisan Budget Act of 2018, Pub. L. 115-123, have eliminated this benefit for tax years after 2017.

84. UNIF. TRANSFERS TO MINORS ACT, 8C U.L.A. 1 (1986) [hereinafter UTMA]. The UTMA was approved by the National Conference of Commissioners on Uniform State Laws in 1983. The UTMA has been enacted in every state except South Carolina. *See Legislative Enactment Status: Transfers to Minors Act*, UNIF. L. COMM’N, <http://www.uniformlaws.org/LegislativeMap.aspx?title=Transfers%20to%20Minors%20Act> [<https://perma.cc/8C98-VFWG>] (last visited Jan. 25, 2018). The UTMA describes itself as a revision and restatement of the Uniform Gifts to Minors Act (“UGMA”), approved by the Conference in 1956 and revised in 1966. The UGMA was in turn developed from the Model Gifts of Securities to Minors Act, sponsored by the New York Stock Exchange and the Association of Stock Exchange Firms, to promote inter vivos gifts of securities to minors. *Prefatory Notes to UTMA*; *see Thomas E. Allison, The Uniform Transfers to Minors Act—New and Improved, But Shortcomings Still Exist*, 10 U. ARK. LITTLE ROCK L.J. 339, 345 (1987).

85. UTMA, *supra* note 84, at § 9.

86. *Jimenez v. Lee*, 547 P.2d 126 (Or. 1976); RESTATEMENT (THIRD) OF TRUSTS § 2 (AM. LAW INST. 2003) (intent to create a trust means an intention to subject “the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee”); *id.*

A. *Income Taxation*

For state law purposes, a custodianship is not a separate legal entity.⁸⁷ Similarly, for federal income tax purposes, the custodianship does not create a separate taxable entity. Rather, the minor is the owner and taxpayer. Income produced by the custodial property, including gain on sale, is taxed to the minor unless it is used to provide for his support, in which case it is taxed to the person who is obligated to support the minor.⁸⁸ However, such income from custodial property taxable to the minor becomes subject to the “kiddie tax” of Section 1(i) of the Internal Revenue Code (the “Code”).⁸⁹ That tax eliminates the benefit of taxing income at the child’s rate, except for annual amounts of income below \$1,000 or so.

B. *Financial Aid*

As a student asset, the asset’s value would enter the *expected family contribution* as a *student contribution from assets*, which is 20% of the value per year.⁹⁰ Additionally, any income earned by the custodial property would be taxed to the student and thereby be included in the financial aid *total income* of the student.

C. *Gift Tax*

Revenue rulings hold that a transfer of property to a minor pursuant to either the Uniform Gifts to Minors Act or the Model Gifts of Securities to Minors Act is both a completed gift for federal gift tax purposes and it qualifies for the annual gift tax exclusion created by section 2503(b) of the Code.⁹¹

§ 13 cmt. b (“the required manifestation of intention to create a trust may be by written or spoken words or by conduct”).

87. *Prefatory Notes* to UTMA.

88. Rev. Rul. 59-357, 1959-2 C.B. 212 (“Income derived from property so transferred [under either the Model Gifts of Securities to Minors Act or the UGMA] which is used in the discharge or satisfaction, in whole or in part, of a legal obligation of any person to support or maintain a minor is taxable to such person to the extent so used, but is otherwise taxable to the minor donee.”) (citing Rev. Rul. 56-484, 1956-2 C.B. 23).

89. *See* Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 710, § 3.02; *see also supra* note 54 and accompanying text.

90. 20 U.S.C. § 108700(a)(3), (h).

91. Rev. Rul. 59-357, 1959-2 C.B. 212 (“Therefore, any transfer of property to a minor under statutes patterned after either the Model Gifts of Securities to Minors Act or the Uniform Gifts to Minors Act constitutes a completed gift for Federal gift tax purposes to the extent of the full fair market value of the property transferred. Such a gift qualifies for the annual gift tax exclusion authorized by section 2503(b) of the [Internal Revenue] Code.”) (citing Rev. Rul. 56-86, 1956-1 C.B. 449).

D. Estate Tax

Custodial property is included in the federal gross estate of a donor only if the donor had served as custodian of the account.⁹² In that situation, the custodial property is included in the donor's federal gross estate under section 2038 of the Code.⁹³ Similarly, the death of a custodian, other than the donor, will not result in inclusion of the custodial property in the custodian's federal gross estate. That is, estate tax exclusion can be achieved for the donor and custodian roles by having someone other than the donor serve as custodian of the account. Conversely, if the minor dies, the custodial property is always included in the minor's federal gross estate.⁹⁴

E. GST Tax

Recall that a transfer to a custodianship is considered a completed gift for federal gift tax purposes that qualifies for the gift tax annual exclusion created by section 2503(b) of the Code. However, if the minor is a *skip person* with respect to the donor, a GST *direct skip* occurs. Nonetheless, to the extent that the transfer qualifies for the gift tax annual exclusion, it simultaneously is also exempt from GST tax as a direct-skip-nontaxable gift. However, if the transfer exceeds the gift tax annual exclusion amount (presently \$14,000 per donor per donee per year), then both gift and GST tax liability could arise, although both likely would be covered by substantial lifetime exclusions.⁹⁵

F. Creditor Protection

Personal creditors of the custodian cannot ordinarily reach custodianship funds.⁹⁶ However, there are exceptions such as fraud (e.g., if the UTMA account was established to defraud the donor's creditors).⁹⁷ Because the funds belong to the minor, his or her creditors can reach the funds.

92. Rev. Rul. 59-357, 1959-2 C.B. 212 (addressing the UGMA and the Model Gifts of Securities to Minors Act); Rev. Rul. 57-366, 1957-2 C.B. 618 (addressing an unspecified "model custodian act").

93. Rev. Rul. 59-357, 1959-2 C.B. 212 (citing Rev. Rul. 57-366, 1957-2 C.B. 618); Lawrence Newman, *The Uniform Gifts to Minors Act in New York and Other Jurisdictions—Tax Consequences, Possible Abuses, and Recommendations*, 49 CORNELL L.Q. 12, 41-43 (1963) (addressing the UGMA).

94. See Rev. Rul. 59-357, 1959-2 C.B. 212.

95. See *supra* note 76 and accompanying text.

96. This follows from the idea that proper UTMA transfers are "irrevocable . . . and the custodial property is indefeasibly vested in the minor . . ." UTMA, *supra* note 84, at § 11.

97. *Friedman v. Mayerhoff*, 592 N.Y.S.2d 909, 912 (Civ. Ct. 1992) ("If it is shown that the account was established by the custodian for a fraudulent purpose and with the aim of shielding his assets from application to a judgment it is possible to have the transfer evidenced by the account set aside.").

G. Use

The UTMA custodian may use custodial property only “as the custodian considers advisable for the use and benefit of the minor, without court order and without regard to (i) the duty or ability of the custodian personally or of any other person to support the minor, or (ii) any other income or property of the minor which may be applicable or available for that purpose.”⁹⁸ Thus, custodial property is committed exclusively to the minor for whom the custodianship was created, but is available for uses other than higher education.

H. Changes in Beneficiary

Because a custodianship is permitted to have only one beneficiary,⁹⁹ custodial property cannot be re-directed to another beneficiary.

I. Other

Under the UTMA, “only one person may be the custodian.”¹⁰⁰ Consequently, succession issues arise when the custodian becomes incapacitated or dies while the custodianship still exists. However, under the UTMA, at any time, a custodian may designate a trust company or an adult (other than a transferor) as successor custodian by “executing and dating an instrument of designation before a subscribing witness other than the successor.”¹⁰¹ Such a designation “does not take effect until the custodian resigns, dies, becomes incapacitated, or is removed.”¹⁰²

Under the UTMA, a custodianship terminates no later than “the minor’s attainment of 21 years of age.”¹⁰³ California permits a custodianship to extend until age 25, but any extension beyond 21 years likely negates the gift tax annual exclusion and the direct-skip-nontaxable gift exemption for GST tax purposes.¹⁰⁴

VI. 2503(C) TRUST TRANSFERS

A Section 2503(c) trust is designed to satisfy the requirements of that section of the Code, which permits transfers to such a trust to qualify for the gift tax annual exclusion under section 2503(b). Absent section 2503(c), transfers to such a trust would be ineligible for the gift tax annual exclusion because the transfers would be a “gift . . . of [a] future interest[] in property”¹⁰⁵ Section 2503(c) reads as follows:

98. UTMA, *supra* note 84, at § 14.

99. *Id.* § 10 (“[a] transfer may be made only for one minor”).

100. *Id.*

101. *Id.* § 18(b).

102. *Id.*

103. *Id.* § 20.

104. I.R.C. § 2503(c) (age twenty-one requirement).

105. *Id.* § 2503(b).

No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom—

- (1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and
- (2) will to the extent not so expended—
 - (A) pass to the donee on his attaining the age of 21 years, and
 - (B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c).¹⁰⁶

A. *Income Taxation*

For federal income tax purposes, a trust creates a separate taxable entity.¹⁰⁷ Section 1 and subchapter J of the Code (sections 641 to 684) provide rules for determining “[t]he taxable income of . . . trust[s].”¹⁰⁸ Under subchapter J, three types of income tax treatment exist. However, for our purposes, only one matters—the complex trust.¹⁰⁹ A complex trust deducts the amount of distributions to its beneficiaries, and those beneficiaries then are taxed on the distributed income. That distribution deduction causes the income taxation of complex trusts to resemble the conduit taxation for partnerships and S corporations. But, for complex trusts, pass-through taxation arises only from actual distributions, not mere ownership alone. Consequently, when a complex trust does not actually distribute all of its income, it faces staggeringly progressive tax rates, entering the highest marginal tax bracket

106. *Id.* § 2503(c).

107. *Id.* § 1(e) (imposing tax upon “the taxable income of . . . every trust”). Grantor trusts are an exception because the grantor rather than the trust (or its beneficiaries) bears the income tax. *Id.* § 671.

108. *Id.* § 641(b) (“The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part.”).

109. The three types are simple trust, complex trust, and grantor trust. Among those, grantor trusts are pure conduits, with the possible exception of net capital losses trapped within the entity. Non-grantor trusts are taxed either as simple or complex trusts, but no meaningful differences exist between those two regimes; rather, only two unimportant differences exist in the treatment of simple and complex trusts. One, the deduction in lieu of a personal exemption is \$300 for trusts required to distribute all income (whether simple or complex) and \$100 for all other trusts. Two, stock-on-stock dividends that are (i) taxable, (ii) allocated to corpus under the instrument or local law, and (iii) not currently distributed are excluded from distributable net income for simple trusts—but not for complex trusts. *Id.* § 643(a)(4). The second difference is a matter of technical, but not practical, significance. Consequently, the distinctions can be ignored and all complex trusts are analyzed as complex trusts. Nonetheless, Form 1041 requires a declaration of whether the trust was simple or complex for the reported period. See *Form 1041*, IRS, <https://www.irs.gov/pub/irs-pdf/f1041.pdf> [<https://perma.cc/ZMF4-NNQ8>] (2017 U.S. income tax return for estates and trusts).

for ordinary income (39.6%) and capital gain (20%) at a mere \$12,500 of income (for 2017).¹¹⁰ In addition, when the trust's income exceeds \$12,500, net investment income taxed to the trust faces an additional 3.8% income tax under section 1411,¹¹¹ for a combined ordinary income tax rate of 43.6% and capital gain tax rate of 23.8% for trust income above \$12,500.

Those high rates of income taxation typically would apply to much of the income of a Section 2503(c) trust used as a higher education savings vehicle. Saving for higher education means not distributing income currently, but rather accumulating it for later use. As with the pure savings model, some income tax deferral could be achieved by investing in tax-advantaged funds, so that the income could be realized in a year when it is distributed. This would allow a distributions deduction and consequent income taxation at the beneficiary's lower rates.¹¹²

B. Financial Aid

The financial aid rules regarding interests in trusts are rudimentary and opaque. The statutory "need analysis" rules do not expressly address them, but administrative pronouncements by the U.S. Department of Education do. Under procedures created by that department, a student applies for financial aid by completing the *Free Application for Federal Student Aid* form ("FAFSA").¹¹³ Rules for completing the FAFSA are provided by *The Federal Student Aid Handbook* ("*FSA Handbook*"). The *FSA Handbook* addresses the financial aid rules regarding trust interests, in which it separately considers the asset and income reporting aspects of trusts.

In regard to reporting trust funds, the *FSA Handbook* states that:

Trust funds *in the name of a student, spouse, or parent* should be reported as that person's asset on the application, generally even if the beneficiary's access to the trust is restricted. If the settlor of a trust has voluntarily placed restrictions on its use, then the student should report its present value as an asset, as discussed below. If a trust has been restricted by court order, however, the student should not report it. An example of such a restricted trust is one set up by court order to pay for future surgery for the victim of a car accident.

How the trust must be reported depends on whether the student (or dependent student's parent) receives or will receive the interest in-

110. Rev. Proc. 2016-55, 2016-45 I.R.B. 707, 709-10, § 3.01.

111. I.R.C. § 1411.

112. If the beneficiary were the student, the "kiddie tax" would apply. *See id.* § 1(g); *see also supra* note 54 and accompanying text.

113. A printed version of the 2017-2018 FAFSA is available at <https://fafsa.ed.gov/fotw1718/pdf/PdfFafsa17-18.pdf> [<https://perma.cc/XF26-2GP2>] (last visited Sept. 7, 2017).

come, the trust principal, or both. In the case of a divorce or separation where the trust is owned jointly and ownership is not being contested, the property and the debt are equally divided between the owners for reporting purposes unless the terms of the trust specify some other method of division.¹¹⁴

For students, spouses, or parents who will receive only the interest from the trust, the *FSA Handbook* states:

[A]ny interest received in the base year must be reported as income. If the interest accumulates and is not paid out, the recipient must report an asset value for the interest she will receive. The trust officer can usually calculate the value of the interest the person will receive while the trust exists. This value represents the amount a third person would be willing to pay for the interest income.¹¹⁵

For persons who will receive the trust principal only, the *FSA Handbook* states:

The person . . . must report as an asset the present value of his right to that principal. For example, if a \$10,000 principal reverts to a dependent student's parents when the trust ends in 10 years and the student is receiving the interest, he would report the interest he received as income and report as a parental asset the present value of his parents' rights to the principal. The present value of the principal can be calculated by the trust officer; it's the amount that a third person would pay for the right to receive the principal 10 years from now—basically, the amount that one would have to deposit now to receive \$10,000 in 10 years.¹¹⁶

For students, spouses, or parents who will receive both the principal and income from the trust, the *FSA Handbook* states that:

[T]he student should report the present value of both interest and principal, as described in the discussion of principal only. If the trust is set up so that the interest accumulates within the trust until it ends, the beneficiary should report as an asset the present value of the interest and principal that she is expected to receive when the trust ends.¹¹⁷

Application of the *FSA Handbook* trust-asset-inclusion rule is doubly unclear. First, under clearly established law, trust funds must be held “in the name of” the trustee.¹¹⁸ Thus, under the first part of the *FSA Handbook* trust-asset-inclusion rule, trust funds would be included in the expected-family-contribution calculation only if the trus-

114. 2017 FSA HB, *supra* note 28, at AVG-19.

115. *Id.*

116. *Id.*

117. *Id.*

118. UNIF. TRUST CODE § 810(c) (UNIF. LAW COMM'N 2010) (“[A] trustee shall cause the trust property to be designated so that the interest of the trust, to the extent feasible, appears in records maintained by a party other than a trustee or beneficiary.”); *see also* RESTATEMENT (SECOND) OF TRUSTS § 179 (AM. LAW INST. 1957) (duty to earmark).

tee is “a student, spouse, or parent.”¹¹⁹ Inclusion depending upon the identity of the trustee is curious because that necessarily means that when an unrelated trustee serves, the assets are not reported.¹²⁰ The second part of the *FSA Handbook* trust-asset-inclusion rule addresses the role of the beneficiary; unfortunately, the *FSA Handbook* merely discusses what is not relevant (beneficiary access) and does not otherwise address how beneficiary identity is relevant. Thus, asset inclusion appears dependent solely on the identity of the trustee, no matter how economically deaf that sounds.

By contrast, application of the *FSA Handbook* trust-income-inclusion rule is clearer: all trust distributions must be included in the financial aid *total income* of the student or parent who receives the distribution. That summary conclusion arises from two rules. First, distributions from trusts must be included in the adjusted gross income of the recipient student or parent (under subchapter J), and then the distributions would find their way into the financial aid *total income* as part of the recipient’s adjusted gross income. Second, distributions from trusts that are not included in the adjusted gross income of the recipient student or parent (such occur under subchapter J when the trust distributes from its principal) nonetheless find their way into the financial aid *total income* of the student or parent as *untaxed income and benefits*.¹²¹

C. Gift Tax

The entire purpose of a Section 2503(c) trust is to qualify the transfer to the trust for the annual exclusion under section 2503(b). Thus, a transfer of property to a Section 2503(c) trust for the benefit of a minor qualifies for the annual gift tax exclusion created by section 2503(b).¹²²

D. Estate Tax

Property held in irrevocable trusts for which the grantor has retained no interest or power are generally not included in the federal

119. *Id.*

120. The *FSA Handbook* trust-reporting rule arguably requires trustees to include the trust assets on their FAFSAs or the FAFSAs of a spouse or child—even when the trustee has no beneficial interest in the trust.

121. 20 U.S.C. § 1087vv(a)–(b). “[T]otal income” is “adjusted gross income plus untaxed income and benefits.” *Id.* § 1087vv(a)(1)(A). “[U]ntaxed income and benefits” expressly includes, among others: “cash support . . . except, for dependent students, funds provided by the student’s parents”; untaxed portion of pensions; contributions to pension plans, when such contributions are excluded from taxable income; contributions to health savings accounts; and “any other untaxed income and benefits.” *Id.* § 1087vv(b)(1)(A)–(I); 2016 FSA HB, *supra* note 26, at AVG-21. Express exclusions from “untaxed income and benefits” exist, but no exclusion includes trust distributions of this sort. *See* § 1087vv(b)(2).

122. I.R.C. § 2503.

gross estate of the grantor. Such would be the situation in a typical Section 2503(c) trust. By contrast, upon the death of the minor, who necessarily is the sole beneficiary of a Section 2503(c) trust, the trust property would be included in the minor's federal gross estate.¹²³ Although, for most trusts, a beneficiary who dies does not include any portion of the trust property in her federal gross estate, section 2503(c) demands that the trust states that "in the event the donee dies before attaining the age of 21 years, [the trust property] be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c)."¹²⁴ The first of those would cause inclusion in the federal gross estate under section 2033; the second, under section 2041.

E. GST Tax

A transfer to a Section 2503(c) trust is a completed gift for federal gift tax purposes that qualifies for the annual gift tax exclusion authorized by section 2503(b) of the Code. If the minor is a *skip person* with respect to the donor, a *direct skip* occurs. Thus, to the extent that contributions to a Section 2503(c) trust are removed from taxable gifts by the gift tax annual exclusion, they simultaneously are removed from GST tax liability as direct-skip-nontaxable gifts.¹²⁵ However, contributions in excess of the gift tax annual exclusion amounts are subject to the gift tax and GST tax; yet, large, multi-million-dollar lifetime exemptions exist to eliminate those taxes.¹²⁶

F. Creditor Protection

Creditor protection for trusts hinges on several factors, including the type of trust (revocable, irrevocable, spendthrift), whether the settlor is a beneficiary, and the extent to which beneficiaries can compel distributions.¹²⁷ Creditor protection for trusts can get even more complicated considering the various domestic (and even foreign) asset protection (e.g., a self-settled spendthrift trust) regimes that have been enacted.¹²⁸

There is no creditor protection for a *revocable* trust because the settlor has the power to revoke the trust.¹²⁹ For irrevocable trusts, "a

123. Rev. Rul. 59-357, 1959-2 C.B. 212.

124. I.R.C. § 2503(c)(2)(B).

125. Section 2642(c) creates a category of "direct skips which are nontaxable gifts." I.R.C. § 2642(c). For them, the inclusion ratio is zero, section 2642(c)(1), which makes the GST tax "applicable rate" equal to zero. I.R.C. § 2641 (applicable rate equals maximum federal estate tax rate times the inclusion ratio).

126. See *supra* note 76 and accompanying text.

127. UNIF. TRUST CODE §§ 501-506 (UNIF. LAW COMM'N 2010).

128. VA. CODE ANN. § 64.2-745.1 (West 2012) (example of recently enacted self-settled spendthrift trust provision).

129. UNIF. TRUST CODE § 505(a)(1) ("During the lifetime of the settlor, the property of a revocable trust is subject to claims of the settlor's creditors.").

creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit."¹³⁰ This, of course, poses serious issues for settlors who are also beneficiaries.¹³¹ From the beneficiary perspective, the default rule is "a creditor or assignee of the beneficiary [can] . . . reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means."¹³² This is a suboptimal result, and it can be avoided by the use of a spendthrift provision. A spendthrift provision "restrains both voluntary and involuntary transfer of a beneficiary's interest."¹³³ If there is a proper spendthrift provision, "a creditor of the beneficiary is prohibited from attaching a protected interest and may only attempt to collect directly from the beneficiary after payment is made."¹³⁴ In sum, ignoring the advent of the domestic self-settled asset protection trust, optimal creditor protection exists for (i) irrevocable trusts with (ii) discretionary distributions¹³⁵ and (iii) a non-beneficiary trustee.

G. *Use*

Under the statutory terms of a Section 2503(c) trust, "the property and the income therefrom . . . may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, . . . and will to the extent not so expended . . . pass to the donee on his attaining the age of 21 years"¹³⁶ Thus, section 2503(c) property is committed exclusively to the minor for whom the trust was created, but is available for uses other than higher education.

H. *Changes in Beneficiary*

Because a Section 2503(c) trust must be for the benefit of "an individual,"¹³⁷ such property cannot be re-directed to another beneficiary.

I. *Other*

Under section 2503(c), the trust property must "pass to the donee on his attaining the age of 21 years,"¹³⁸ a rule substantially similar to that for state-law UTMA custodial property. However, with a Section 2503(c) trust, a donor can write her own trust, rather than being lim-

130. *Id.* § 505(a)(2).

131. These issues might be mitigated by a self-settled spendthrift trust statute.

132. UNIF. TRUST CODE § 501.

133. *Id.* § 502(a).

134. *Id.* § 502 cmt.

135. *Id.* § 504(b) (providing, with some exceptions, "whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion").

136. I.R.C. § 2503(c) (2012).

137. *Id.* § 2503(c).

138. *Id.*

ited to the statutory UTMA, and can continue the trust past the donee's reaching 21, so long as the trust gives the donee a right to withdraw the property, which withdrawal right can be time limited.¹³⁹

VII. CRUMMEY TRUST TRANSFERS

As we have seen, a general gift tax annual exclusion exists under section 2503(b), but it is unavailable for gifts of future interests. That future-interest-denial rule has been interpreted to require that the beneficiary have a definite right to a certain amount of property, the value of which establishes the amount eligible for the annual exclusion.¹⁴⁰ Consequently, gifts to UTMA's and to Section 2503(c) trusts would be denied an annual exclusion under section 2503(b); yet, the specific statutory authorization of section 2503(c) rescues the annual exclusion for them.

A more general solution to the future-interest-denial rule is the so-called *Crummey* withdrawal right.¹⁴¹ Under a *Crummey* right, contributions to a purely discretionary trust for the benefit of multiple beneficiaries can still qualify for the gift tax annual exclusion as long as the trust grants one or more donees a right to withdraw property. The amount that is permitted to be withdrawn establishes the amount that is eligible for the annual exclusion. *Crummey* withdrawal rights typically are limited in both the amount that can be withdrawn and the duration of time for withdrawal. The rights are limited in amount to the lesser of the current inflation-adjusted section 2503(b) limit and the amount transferred. In duration, the rights are limited to thirty days from the date of the transfer, but the lapsing of the power creates its own transfer tax consequences for the lapsed power holder. To cure the problems besetting the lapsed power holder, hanging *Crummey* powers are sometimes created.¹⁴² The education-savings consequences

139. The IRS has publicly ruled that a trust satisfies the post age-twenty-one provisions of section 2503(c) by including either (1) a continuing right to compel immediate distribution of the trust corpus by giving written notice to the trustee, or (2) a right during a limited period to compel immediate distribution of trust corpus, by written notice to the trustee. Rev. Rul. 74-43, 1974-1 C.B. 285. The IRS has privately ruled that periods between thirty and sixty days satisfy the "limited period" requirement for the second prong. See I.R.S. Priv. Ltr. Rul. 85-21-089 (Feb. 26, 1985); I.R.S. Priv. Ltr. Rul. 78-24-035 (Mar. 15, 1978); I.R.S. Priv. Ltr. Rul. 78-05-037 (Nov. 4, 1977).

140. *Md. Nat'l Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979) ("The Internal Revenue Code's 'present interest' differs from the technical concept of a present estate for life or a term of years, because even a vested interest may be considered a 'future interest' for gift tax purposes if the donee gets no immediate use, possession, or enjoyment of the property. The donor is entitled to the exclusion only if he has conferred on the donee 'the right to substantial present economic benefit.'") (quoting *Fondren v. Comm'r*, 324 U.S. 18, 20 (1945)).

141. Named for the famous case, *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).

142. See Daniel B. Evans, *Drafting Crummey Powers*, 1 PROB. & PROP. 54, 55, 58 (1987).

for a *Crummey* trust largely mirror those for a Section 2503(c) trust, although there are some important differences.

A. *Income Taxation*

The income taxation rules for Section 2503(c) trusts described in Section VI.A apply to *Crummey* trusts.

B. *Financial Aid*

The financial aid rules for Section 2503(c) trusts described in Section VI.B. apply to *Crummey* trusts.

C. *Gift Tax*

The animating purpose of a *Crummey* trust is to create a beneficiary withdrawal right sufficient to qualify transfers to the trust for the gift tax annual exclusion under section 2503(b). Creating withdrawal rights in multiple individuals correspondingly multiplies the amount of the exclusion. For instance, withdrawal rights granted to individuals with contingent trust interests nonetheless permit use of the section 2503(b) exclusion.¹⁴³ However, while the Internal Revenue Service (the “IRS”) has ruled privately that it will generally not contest *Crummey* powers held by current income and vested remainder beneficiaries, it may contest withdrawal rights held by discretionary beneficiaries or by beneficiaries with remote contingent interests in the trust.¹⁴⁴

Contributions to trusts in excess of the gift tax annual exclusion amounts would be subject to the gift tax; however, a large, multi-million-dollar lifetime exemption exists to eliminate those taxes.¹⁴⁵

D. *Estate Tax*

Property held in irrevocable trusts for which the grantor has retained no power are generally not included in the federal gross estate of the grantor. Such would be the case in a typical *Crummey* trust. Additionally, in a properly structured *Crummey* trust, upon the death of a beneficiary, little or no trust property is included in the beneficiary’s federal gross estate (unlike in a Section 2503(c) trust).

143. *Cristofani v. Comm’r*, 97 T.C. 74, 82–83 (1991).

144. I.R.S. Tech. Adv. Mem. 96-28-004 (Apr. 1, 1996) (“[W]here nominal beneficiaries enjoy only discretionary income interests, remote contingent rights to the remainder, or no rights whatsoever in the income or remainder, their non-exercise indicates that there was some kind of prearranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences, or both.”).

145. See *supra* note 76 and accompanying text.

E. *GST Tax*

A transfer to a *Crummey* trust is a completed gift for federal gift tax purposes that qualifies for the annual gift tax exclusion authorized by section 2503(b) of the Code. However, unlike direct transfers, transfers to UTMA custodial accounts, and transfers to Section 2503(c) trusts, the qualification of transfers to *Crummey* trusts for the gift tax annual exclusion does not automatically remove the transfers from GST tax liability. While direct, UTMA, and section 2503(c) transfers qualify as “direct skips which are nontaxable gifts”¹⁴⁶ under section 2642(c), transfers to *Crummey* trusts do not. The direct-skip-nontaxable-gift definition requires that for transfers to trust for the benefit of an individual: “(A) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and (B) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.”¹⁴⁷ Thus, for transfers to trust to qualify as direct-skip-nontaxable gifts, the trust must be for the benefit only of one individual. Section 2503(c) trusts meet that requirement, as it is imposed independently by section 2503(c). A *Crummey* trust could meet the one-beneficiary requirement, but it typically does not as *Crummey* trusts exist to pool capital for multiple beneficiaries, each with a time-limited withdrawal power.

Consequently, transfers to *Crummey* trusts for the benefit of skip persons typically become subject to the GST tax.¹⁴⁸ As such, the transferor would be required to allocate some of her multi-million-dollar GST tax exemption to such transfers.¹⁴⁹

146. I.R.C. § 2642(c).

147. I.R.C. § 2642(c)(2)(A)–(B) (2012).

148. If all the beneficiaries of the *Crummey* Trust are skip persons, then the transfer to the trust is a direct skip. *Id.* § 2613 (defining a skip person to include a trust in which all interests are held by skip persons). If one or more beneficiaries are not skip persons, as would be the case if children of the transferor were permissive or mandatory beneficiaries, then the transfer to the trust would not be a direct skip; therefore, GST tax consequences would arise upon a taxable distribution or taxable termination.

149. Section 2632 of the Internal Revenue Code automatically allocates GST exemption to direct skips and to indirect skips, the latter defined as a transfer to a “GST trust.” I.R.C. § 2632(b)–(c). A taxpayer may elect out of the deemed allocations. *Id.* § 2632(b)(3), (c)(5). Most *Crummey* Trusts would constitute “GST trusts” so that transfers to them would be indirect skips and consequently have GST exemption automatically allocated to them. Keeping track of transfers that are simultaneously exempt from gift tax but not from GST tax creates opportunity for error. Beth Shapiro Kaufman & Megan E. Wernke, *Allocating Generation-Skipping Transfer Tax Exemption*, 21 CAL. TR. & EST. Q. 22, 23 (2015) (“[T]he omission of a non-taxable gift from Schedule A [on Form 709] can cause major issues for later return preparers and estate planners who rely on previously filed Forms 709 as evidence of clients’ remaining GST exemptions.”).

F. *Creditor Protection*

The same rules for Section 2503(c) trusts described in Section VI.F apply to *Crummey* trusts.

G. *Use*

The only tax-required aspect of a *Crummey* trust is a properly structured beneficiary withdrawal right. Otherwise, the trust's terms are within the trust settlor's discretion. So, trust funds can be used for any settlor-desired purpose and are not limited to higher education uses. Of course, that is an important benefit of a *Crummey* trust, as compared to other savings strategies.

H. *Changes in Beneficiary*

The typical *Crummey* trust operates as a purely discretionary trust, except to the extent that the beneficiaries can exercise their time-limited withdrawal rights. Consequently, the trustee can distribute trust property for any purpose to any beneficiary. This flexibility is another important benefit of a *Crummey* trust, as compared to other savings strategies.

I. *Other*

The *Crummey* trust entails great preparation and incurs the ongoing costs of trust administration. However, property other than cash can be transferred, and there are no tax-required limits on investment discretion.

VIII. SECTION 529 PLANS

Section 529 creates a category of *qualified tuition programs*, more commonly called *Section 529 Plans*. There are two types of *Section 529 Plans*: Education Savings Accounts, which can be established only by states of the United States, and Prepaid Education Arrangements, which can be established either by states of the United States or by one or more educational institutions.¹⁵⁰ In a Prepaid Education Arrangement, the amount of future tuition is guaranteed by the plan, so rather than increasing or decreasing with investment performance, the contribution earns a return at a rate equal to increases in tuition. By contrast, in an Education Savings Account, the ultimate value of the account depends upon the performance of the investments in the plan. Thus, in evaluating a Section 529 Plan as a savings vehicle, the discussion will focus on Education Savings Accounts.

An Education Savings Account has several restrictions not present in other savings models. Restrictions include that (1) contributions

150. See WAYNE M. GAZUR & ROBERT M. PHILLIPS, *ESTATE PLANNING: PRINCIPLES AND PROBLEMS* 197 (4th ed. 2015).

must be made in cash,¹⁵¹ (2) for the benefit of only one designated beneficiary, (3) for which investment direction is limited to two changes per calendar year,¹⁵² and (4) for which excess contributions are prohibited.¹⁵³

A. *Income Taxation*

Contributions to Section 529 Plans give rise to state income tax deductions in some states,¹⁵⁴ but not to a federal income tax deduction. Section 529 Plans themselves are exempt from income taxation,¹⁵⁵ so earnings within them grow free of income tax. Upon distribution, the amounts distributed are income tax exempt if (1) used for “qualified higher education expenses” at an “eligible educational institution”¹⁵⁶ or if (2) rolled-over to either (i) another account for the same designated beneficiary or (ii) an account for a new designated beneficiary who is a member of the same family as the former designated beneficiary.¹⁵⁷

Not-taxable distributions used for “qualified higher education expenses” at an “eligible educational institution.” *Qualified higher education expenses* include required (1) tuition; (2) fees; (3) books, supplies, and equipment; and (4) room and board if the student is attending classes at least half-time. The amount of room and board is set by the educational institution either (i) in calculating its *cost of attendance* for off-campus housing or (ii) in the amount actually charged for on-campus housing.¹⁵⁸

Under section 529(e), *eligible educational institution* “means an institution . . . (A) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on the date of the enactment of [section 529(e)] . . . , and (B) which is eligible to participate in a program under title IV of such Act.”¹⁵⁹ Notwithstanding the

151. I.R.C. § 529(b)(2).

152. *Id.* § 529(b)(4).

153. *Id.* § 529(b)(6). The Code does not define “excess contributions;” but the regulations create a safe harbor when “total contributions” are limited to “actuarial estimates” for paying five times the highest annual undergraduate cost of attendance. Prop. Treas. Reg. § 1.529-2(i)(2), 63 Fed. Reg. 45,019, 45,028 (Aug. 24, 1998). That safe harbor also refers to an absolute ban on “additional contributions” at a “specified account balance limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment.” *Id.*

154. *See, e.g.,* VA. CODE ANN. § 58.1-322.03(d)(7)(a) (West 2017).

155. I.R.C. § 529(a). A Section 529 Plan is subject to the unrelated business income tax of section 511. *Id.*

156. *Id.* § 529(c)(1), (c)(3)(B).

157. *Id.* § 529(c)(3)(C).

158. *Id.* § 529(e)(3)(A)–(B). Effective for distributions made after December 31, 2017, “qualified higher education expenses” include up to \$10,000 per beneficiary per year in tuition (not other expenses) “in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.” *Id.* §§ 529(c)(7), (e)(3)(A).

159. *Id.* § 529(e)(5).

cross-reference in section 529(e), a definition of *eligible educational institution* does not appear in 20 U.S.C. section 1088. However, IRS *Publication 970* provides:

Eligible educational institution . . . [is] [a]ny college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.¹⁶⁰

The publication also adds, “[c]ertain educational institutions located outside the United States also participate in the U.S. Department of Education’s Federal Student Aid (FSA) programs.”¹⁶¹

Not-taxable distributions constituting “rollovers.” A “distribution which, within 60 days of such distribution, is transferred” either (i) “to another [Section 529 Plan] . . . for the benefit of the designated beneficiary”¹⁶² or (ii) “to the credit of another designated beneficiary . . . who is a member of the family of the designated beneficiary with respect to which the distribution was made”¹⁶³ is exempt from income tax.¹⁶⁴ A *member of the family* with respect to a designated beneficiary means that beneficiary’s spouse; descendants; stepchildren and their descendants; siblings, step-siblings, half-siblings; ancestors; step-parents; sons or daughters of a sibling or half-sibling; sibling or half-sibling of a parent; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; spouses of those relatives previously listed; and first cousins.¹⁶⁵

Distributions neither used for qualified higher education expenses nor properly rolled over are included in gross income under section 72 as ordinary income.¹⁶⁶ In addition to income inclusion under section 72, section 529(c)(6), with some exceptions, adds a penalty equal to 10% of the amount included in gross income.¹⁶⁷ However, the identity of the individual who must report that income and penalty, the so-called distributee, depends upon whether the income-reportable event was (i) a distribution not used for qualified higher education expenses

160. INTERNAL REVENUE SERV., DEPT. OF TREAS., PUB. NO. 970, TAX BENEFITS FOR EDUCATION 61 (Jan. 18, 2017), available at <https://www.irs.gov/pub/irs-pdf/p970.pdf> [https://perma.cc/5C8S-M2GQ].

161. *Id.*

162. I.R.C. § 529(c)(3)(C)(i)(I).

163. *Id.* § 529(c)(3)(C)(i)(II).

164. *Id.* § 529(c)(3)(C)(i).

165. *Id.* § 529(e)(2).

166. *Id.* §§ 72, 529(c)(3)(A)–(B).

167. *Id.* §§ 529(c)(6), 530(d)(4).

or (ii) a rollover to a Section 529 Plan account for a new, non-family designated beneficiary.¹⁶⁸

When there has been a distribution not used for qualified higher education expenses, the identity of the distributee is clear: it is the person who received the distribution, and that person must be either the sole designated beneficiary or the account owner. When a rollover is made to an account for a non-family designated beneficiary, the distributee's identity is not clear. Proposed Treasury Regulations, issued nineteen years ago and not yet finalized, treat the income distributee as the account owner.¹⁶⁹ The *account owner* is defined as:

the person who, under the terms of the [Section 529 Plan] . . . or any contract setting forth the terms under which contributions may be made to an account for the benefit of a designated beneficiary, is entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated.¹⁷⁰

Because the method of taxation is under section 72, the account owner would not be taxable on the contributions made, but only on the earnings. However, under a Notice issued in 2008, the account owner must prove the amount of her contributions, so a successor account owner would be taxable on the entire distribution.¹⁷¹

Under sections 72 and 529, certain exceptions exist to the 10% penalty (but not the underlying tax) for taxable distributions (i.e., those neither used for qualified higher education expenses nor properly rolled-over). The exceptions to the penalty include the following situations: (1) death of the designated beneficiary (when paid to a beneficiary or designated beneficiary's estate); (2) disability of the designated beneficiary when the designated beneficiary is unable to engage in substantial gainful activity because of a medically determinable physical or mental impairment expected to result in death or to be of long

168. *Id.* § 529(c)(3). Section 529(c)(3) provides that “[a]ny distribution under a [Section 529 Plan] shall be includible in the gross income of the distributee in the manner as provided under section 72 to the extent not excluded from gross income under any other provision of this chapter.” *Id.*

169. Prop. Treas. Reg. § 1.529-3(c)(1), 63 Fed. Reg. 45,019, 45,030 (Aug. 24, 1998). The 2008 Advance Notice continues those rules. Guidance on Qualified Tuition Programs Under Section 529: Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3441, 3445 (Jan. 18, 2008) (Rules 4 and 5).

170. Prop. Treas. Reg. § 1.529-1(c).

171. Guidance on Qualified Tuition Programs Under Section 529, 73 Fed. Reg. at 3443 (“The IRS and the Treasury Department expect to develop additional rules to address these and other similar transactions by [account owners] AOs, including (1) limiting AOs to individuals; and, (2) making the AO liable for income tax on the entire amount of the funds distributed for the AO’s benefit except to the extent that the AO can substantiate that the AO made contributions to the section 529 account and, therefore, has an investment in the account within the meaning of section 72.”).

continued and indefinite duration; (3) a scholarship or tuition waiver (up to amount of scholarship, etc.); (4) veterans education assistance; (5) employer-provided educational assistance; (6) attending a U.S. service academy; and (7) from coordination with other federal tax higher education benefits.¹⁷²

B. *Financial Aid*

Section 529 Plans have their own particular statutory rules within the financial aid need analysis, which is the category of *qualified education benefits*, consisting only of Section 529 Plans and Coverdell Education Savings Accounts.¹⁷³ Regarding the inclusion of them as assets within the need analysis, the statute states the following: “A qualified education benefit shall be considered an asset of—(A) the student if the student is an independent student; or (B) the parent if the student is a dependent student, regardless of whether the owner of the account is the student or the parent.”¹⁷⁴ The statute does not address inclusion when the student is dependent and the owner of the account is neither the student nor parent (i.e., a third-party owner, such as a grandparent being the owner of the account).

Non-third-party owner. For a dependent student and an account owner of either the parent or student, the Section 529 Plan is an asset of the parent.¹⁷⁵ But in such a situation, any actual distributions that are income-tax exempt are not included in “total income” for financial aid purposes.¹⁷⁶ Thus, for each year, 5.6% of the value of the Section 529 Plan is included in the expected family contribution.

Third-party owner. If the Section 529 Plan is owned by someone other than the parent or student, its value is not included in the assets of either the parent or child. At first blush, the asset rule appears to create a preference for third-party ownership. However, when a distribution is made—even when that distribution is not included in anyone’s gross income for federal income tax purposes—that distribution is counted as student income for financial aid purposes.¹⁷⁷ Recall that 50% of dependent student income is included in the expected family contribution. Therefore, third-party ownership keeps the plan assets out of the expected-family-contribution calculation, but at the expense of including 50% of all distributions within it.

172. I.R.C. §§ 530(d)(4), 25A(g)(2), 72(m)(7).

173. 20 U.S.C. § 1087vv(f)(5) (2012).

174. *Id.* § 1087vv(f)(3).

175. *Id.* Recall that a parent asset is expended at 5.64% per year and an independent student asset is expended at 20% per year. *See supra* notes 32–33 and accompanying text.

176. 20 U.S.C. § 1087vv(a)(2), (f)(3), (f)(5).

177. *Id.* § 1087oo(g)(5); 2016 FSA HB, *supra* note 26, at AVG-18.

C. Gift Tax

The Code treats contributions to a Section 529 Plan as completed gifts that are not future interests, because absent that particular rule, such contributions would not be completed gifts and would be gifts of future interests.¹⁷⁸ Under ordinary rules for gift taxation, a contribution to a Section 529 Plan would not be considered a completed gift when the donor is the account owner (as is often the case), because the donor could change the designated beneficiary, rendering the gift incomplete.¹⁷⁹ In addition, a contribution to a Section 529 Plan would be considered a gift of a future interest, and consequently not eligible for the annual exclusion, because the value of the designated beneficiary's interest is not presently ascertainable, as the amount that the designated beneficiary will receive is entirely within the account owner's discretion.¹⁸⁰

Section 529(c)(2)(A) abrogates both of those ordinary rules by flatly providing, "Any contribution to a [Section 529 Plan] . . . on behalf of any designated beneficiary . . . shall be treated as a completed gift to such beneficiary which is not a future interest in property" ¹⁸¹ Therefore, a contribution to a Section 529 Plan is always a completed gift even if the donor becomes the account owner and is always eligible for the annual exclusion. Moreover, the preferred gift tax treatment for contributions to Section 529 Plans does not stop there, as section 529(c)(2)(B) permits a donor to accelerate five years' worth of annual exclusions.¹⁸²

In addition, section 529 addresses the gift tax consequences of changes in the designated beneficiary. But, because those rules combine the gift tax and GST tax consequences, discussion of them will occur in the GST tax section.

D. Estate Tax

Under ordinary rules for estate taxation, the value of a Section 529 Plan would be includible in the donor's estate when (as is often the case) the donor was the account owner, because the donor's power to change the designated beneficiary would cause inclusion under section

178. I.R.C. § 529(c)(2)(A)(i) (2012).

179. Treas. Reg. § 25.2511-2(c) (1983) ("A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.").

180. Treas. Reg. § 25.2503-3(c), exs. 1, 3 (1984).

181. I.R.C. § 529(c)(2)(A)(i).

182. *Id.* § 529(c)(2)(B) ("If the aggregate amount of contributions described in subparagraph (A) during the calendar year by a donor exceeds the limitation for such year under section 2503(b), such aggregate amount shall, at the election of the donor, be taken into account for purposes of such section ratably over the 5-year period beginning with such calendar year.").

2038.¹⁸³ However, section 529(c)(4)(A) provides that “[n]o amount shall be includible in the gross estate of any individual . . . by reason of an interest in a [Section 529 Plan],” but section 529(c)(4)(B) provides that “[s]ubparagraph (A) shall not apply to amounts distributed on account of the death of a beneficiary.”¹⁸⁴

Surprisingly, deciding how section 529(c)(4)’s gross-estate-exclusion rule modifies the ordinary rules of estate taxation is no easy matter. The IRS has significantly altered its preliminary guidance on the matter. The 1998 Proposed Treasury Regulations stated that estate inclusion never results for the donor or account owner, except for a donor who made the five-year annual exclusion election and died prior to the expiration of the five-year period.¹⁸⁵ Regarding estate inclusion for the designated beneficiary, the 1998 Proposed Regulations stated, “The gross estate of a designated beneficiary of a [Section 529 Plan] . . . includes the value of any interest in the [Section 529 Plan]”¹⁸⁶ Determining the value of the designated beneficiary’s interest is not described, nor is that matter entirely clear, particularly given that under ordinary gross-estate-inclusion rules, the designated beneficiary’s estate would not include anything because the designated beneficiary did not own or control the plan.¹⁸⁷ A 2008 Advance Notice of Proposed Rulemaking addressed this incongruity in the 1998 Proposed Regulations:

Under section 529(c)(4)(B), amounts distributed on account of the death of a [designated beneficiary] . . . are subject to estate tax. The legislative history (H.R. Rep. No. 148 at 328) makes no reference to the term “distributed” but provides that the value of any interest in a section 529 account will be includible in the estate of a [designated beneficiary]. . . . Section 1.529-5(d)(3) of the 1998 proposed regulations adopts the position stated in the legislative history. This position has raised several concerns because, under generally applicable transfer tax provisions, the gross estate of a decedent does not include property in which the decedent has no interest, or over which the decedent has no power or control.¹⁸⁸

183. *Id.* § 2038(a)(1) (including in the federal gross estate transfers “where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate”).

184. *Id.* § 529(c)(4)(A), (B).

185. Prop. Treas. Reg. § 1.529-5(d)(1)-(2), 63 Fed. Reg. 45,019, 45,032 (Aug. 24, 1998).

186. *Id.* § 1.529-5(d)(3), 63 Fed. Reg. at 45,032.

187. In other words, neither sections 2033, 2036, nor 2038 (nor any other section) would require the account to be included.

188. Guidance on Qualified Tuition Programs Under Section 529: Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3441, 3445 (Jan. 18, 2008). The Advance Notice of Proposed Rulemaking did not publish proposed regulations, but stated that “the IRS and the Treasury Department intend to issue a notice of proposed rulemaking” and included an extensive “discussion set[ting] forth the rules expected to be

The 2008 Notice then asserts, "It is anticipated that the forthcoming notice of proposed rulemaking will provide the following rules regarding the tax consequences arising from the death of a [designated beneficiary]" ¹⁸⁹ Next, the Notice sets forth five numbered rules. ¹⁹⁰ Under those five numbered rules, estate inclusion occurs for a designated beneficiary only when "the [account owner] . . . distributes the entire section 529 account to the estate of the [deceased beneficiary] . . . within 6 months of the death of the [deceased beneficiary]. . . ." ¹⁹¹ No other instance of estate tax inclusion exists within those five numbered rules. ¹⁹²

Consequently, under the statute, the 1998 Proposed Regulations, and the 2008 Notice, estate tax inclusion will rarely occur. No amount is included in a donor's or account owner's federal gross estate by reason of her having contributed to or owned a Section 529 Plan. One exception to estate tax inclusion is the unusual case of a five-year annual exclusion election and a death prior to the expiration of the five-year period. No amount is included in a designated beneficiary's estate, except in the rare case of an account owner distributing the entire account to a beneficiary's estate within six months of that beneficiary's death. ¹⁹³

E. GST Tax

As noted earlier, the gift and GST tax consequences for Section 529 Plans are intertwined. Those consequences must be addressed at two points: upon contribution and upon changes in the designated beneficiary. Upon contribution, a taxable gift is made; however, a gift tax annual exclusion is available, as is an election to accelerate five years' worth of gift tax annual exclusions. The GST tax consequences upon contribution fit hand in glove. To the extent that the contributions are removed from taxable gifts by the gift tax annual exclusion, they si-

included in the notice of proposed rulemaking and explain[ing] the rationale for these rules." *Id.* at 3442.

189. *Id.* at 3445.

190. *Id.*

191. *Id.*

192. However, general reference is made to two statutory exceptions existing against the general section 529 rule of no estate inclusion; only one exception, relating to amounts distributed on the death of the designated beneficiary, is described; presumably the second is for a donor who made the five-year annual exclusion election and died prior to the expiration of the five-year period. *Id.* at 3445 ("Section 529(c)(4) provides that, with two exceptions, no amount shall be includible in the gross estate of any individual for purposes of the estate tax by reason of an interest in a section 529 account. The exception relevant to this discussion is for amounts distributed on account of the death of the [designated beneficiary].").

193. I.R.C. § 529(c)(4) (2012); Prop. Treas. Reg. § 1.529-5(c), 63 Fed. Reg. 45,019, 45,032 (Aug. 24, 1998); Advance Notice of Proposed Rulemaking, 73 Fed. Reg. at 3445.

multaneously are removed from GST tax liability.¹⁹⁴ However, contributions in excess of the gift tax annual exclusion amounts would be subject to gift tax and GST tax; yet, large, multi-million-dollar exemptions exist to eliminate those taxes.¹⁹⁵

For changes in the designated beneficiary, three taxes intertwine: (1) gift, (2) GST, and (3) income. The table below summarizes their intersection. “DB” denotes designated beneficiary.

Relation of New DB to Old DB	Gift	GST	Income
Same Family and Same or Higher Generation	No	No	No
Same Family and One Generation Below ¹⁹⁶	Yes	No	No
Same Family and More than One Generation Below	Yes	Yes	No
Not Same Family Generation Assignment Irrelevant	Yes	Yes	Yes ¹⁹⁷

Whenever a change in designated beneficiary renders the transaction subject to gift tax, such change is treated as a new contribution¹⁹⁸ to which the annual exclusion and five-year election are available.¹⁹⁹ Additionally, whenever the change in designated beneficiary renders the transaction subject to GST tax, the availability of annual exclusions simultaneously exempts the transaction from GST tax.²⁰⁰ However, with changes in designated beneficiary, the amount involved will be the account value at that time,²⁰¹ which, having grown over time, will make exhaustion of the annual exclusion limit more likely.

Although the incidence of the gift, GST, and income taxes upon changes in the designated beneficiary are reasonably well known—remarkably—the identity of the transferor liable for paying the tax is not: the statute is silent.²⁰² Section 529(c)(5)(B), which clarifies how

194. Section 2642(c) creates a category of “direct skips which are nontaxable gifts.” I.R.C. § 2642(c). For them, the inclusion ratio is zero, section 2642(c)(1), which makes the GST tax “applicable rate” equal to zero. *Id.* § 2641 (applicable rate equals maximum federal estate tax rate times the inclusion ratio). The proposed regulations give away an important GST issue.

195. *See supra* note 76 and accompanying text.

196. Prop. Treas. Reg. § 1.529-5(b)(3)(ii), 63 Fed. Reg. at 45,032.

197. *Id.* § 1.529-3(c)(1), 63 Fed. Reg. at 45,030.

198. *Id.* § 1.529-5(b)(3)(ii), 63 Fed. Reg. at 45,032.

199. *Id.* § 1.529-5(b)(2), 63 Fed. Reg. at 45,031.

200. *Id.* § 1.529-5(b)(1), 63 Fed. Reg. at 45,031.

201. *Id.* § 1.529-5(b)(3)(iii), 63 Fed. Reg. at 45,032.

202. Generally, for transfer taxes, the transferor is primarily liable for any tax due. I.R.C. §§ 2001(a), 2501(a)(1), 2603(a)(2)–(3) (2012). However, for a direct skip, the GST tax is paid by the transferee. *Id.* § 2603(a)(1).

gift and GST taxes are imposed when a change in designated beneficiary is made, does not identify the transferor. The 1998 Proposed Regulations designate the transferor as the former designated beneficiary.²⁰³ The 2008 Notice designates the account owner.²⁰⁴ While it seems quite odd to have the identity of the transferor in flux, these taxes are so easily avoided by naming a new designated beneficiary within the same family and with the same or higher generation. Hence, the issue may rarely arise.²⁰⁵

Additionally, the 2008 change makes imposition of GST tax more likely. Recall that the 1998 Proposed Regulations treats the former beneficiary as the transferor when determining whether a change in designated beneficiary resulted in GST tax liability; whereas, the 2008 Notice treats the account owner as the transferor. Because the account owner will nearly always be in a higher generation than the former designated beneficiary, imposition of GST tax is more probable.

F. *Creditor Protection*

Federal bankruptcy law protects Section 529 Plans (with some limitations) by removing those assets from the bankruptcy estate.²⁰⁶ Many states similarly protect Section 529 Plans; but the state law protection can hinge on various factors. For example, some states protect Section 529 Plans only if they were sponsored in that state.²⁰⁷ Some states limit the protection to only the designated beneficiary, while other states do not have such limitations (that is, the protection extends to the designated beneficiary and account owner).²⁰⁸

G. *Use*

The only qualified use for Section 529 Plans is to pay qualified higher education expenses.²⁰⁹ In that case, the great benefit of income

203. Prop. Treas. Reg. § 1.529-5(b)(3)(ii), 63 Fed. Reg. at 45,032 (“A transfer which occurs by reason of a change in the designated beneficiary . . . will be treated as a taxable gift by the *old beneficiary* to the new beneficiary if the new beneficiary is assigned to a lower generation than the old beneficiary, . . . [and] will be subject to the generation-skipping transfer tax if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the *old beneficiary*.” (emphasis added)).

204. Guidance on Qualified Tuition Programs Under Section 529, Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3441, 3443 (Jan. 18, 2008) (“[A] change of [designated beneficiary] that results in the imposition of any tax will be treated as a deemed distribution to the [*account owner*] followed by a new gift.” (emphasis added)).

205. Nevertheless, it may be a trap for the unwary.

206. 11 U.S.C. § 541(b).

207. See, e.g., KAN. STAT. ANN. § 60-2308(f) (West 2016); VA. CODE ANN. § 23.1-707(F) (West 2016).

208. See generally Susan T. Bart, *No Taxpayer Left Behind: Tax-Wise Techniques for Funding Education*, ST041 ALI-CLE 173, app. III (2012).

209. I.R.C. § 529(c)(3)(A)–(B).

tax elimination exists. Any other use generates income tax liability and a 10% penalty unless some exception to the penalty applies.²¹⁰

H. *Changes in Beneficiary*

The account owner retains near unlimited rights to change the beneficiary of a Section 529 Plan. The only significant nontax limit is the requirement that such a plan have only one designated beneficiary at a time. As noted earlier regarding taxation, changes in beneficiary in which the new and old beneficiary are not within the same family give rise to significant tax consequences. However, changes within the same family do not, as long as the new and old are within the same or higher generation assignment for GST tax purposes.

I. *Other*

Section 529 Plans have low preparation and little ongoing costs. The plan documents are created by the plan sponsor. A reasonably competitive market exists to keep operating costs low. Contributions must be in cash, and investment direction is limited to two changes per year.²¹¹

IX. COVERDELL EDUCATION SAVINGS ACCOUNTS

Coverdell Education Savings Accounts (“Coverdell ESAs”) are a smaller, substantially restricted and yet slightly expanded version of Section 529 Plans. The only significant advantage to Coverdell ESAs is that distributions may be used broadly for the costs of elementary and secondary education;²¹² while Section 529 Plans are limited to higher education plus up to \$10,000 per beneficiary per year for tuition at an elementary or secondary school.²¹³ Conversely, there are substantial restrictions on Coverdell ESAs compared to Section 529 Plans. Contributions to Coverdell ESAs are limited to \$2,000 per year,²¹⁴ phased out for contributors with upper middle-class in-

210. *Id.* §§ 72, 529(c)(3)(A).

211. *Id.* § 529(b)(4).

212. *Id.* § 530(b)(2)–(3) (defining “qualified education expenses” to include “qualified elementary and secondary education expenses” as well as “qualified higher education expenses”).

213. *Id.* § 529(e)(3)(A) (defining “qualified higher education expenses”); § 529(c)(7) (“Any reference in this subsection to the term ‘qualified higher education expense’ shall include a reference to expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.”); § 529(e)(3)(A) (flush language) (“The amount of cash distributions from all qualified tuition programs . . . with respect to a beneficiary during any taxable year shall, in the aggregate, include not more than \$10,000 in expenses described in subsection (c)(7) incurred during the taxable year.” The latter two provisions were added, effective for distributions made after December 31, 2017, by section 11032 of the Act commonly known as the “Tax Cuts and Jobs Act,” Pub. L. No. 115-97, 131 Stat. 2054, 2081 (2017).

214. *Id.* § 530(b)(1)(A)(iii).

comes,²¹⁵ and prohibited once the beneficiary turns 18.²¹⁶ In addition, the entire balance of the account must be distributed within thirty days of either the beneficiary's death or turning age thirty, whichever comes earlier.²¹⁷

A. *Income Taxation*

The income taxation of Coverdell ESAs mirrors that of Section 529 Plans, with two alterations to the tax-free distribution rules: one rule is expanded, one contracted. Amounts distributed from Coverdell ESAs are income-tax exempt if they are (1) used for *qualified education expenses* (including both *qualified higher education expenses*, as defined in section 529, and *qualified elementary and secondary education expenses*, as defined in section 530),²¹⁸ or (2) rolled over to either (i) another account for the same designated beneficiary or (ii) an account for a new designated beneficiary who falls within the same family as the former designated beneficiary and for which the new designated beneficiary has not attained age thirty.²¹⁹ Thus, there is an expansion to cover qualified elementary and secondary education expenses, but a contraction for permitted rollovers by requiring that the new designated beneficiary be under age thirty.

B. *Financial Aid*

Coverdell ESAs have their own particular statutory rules within the category of *qualified education benefits*, which consists only of Section 529 Plans and Coverdell ESAs.²²⁰ Consequently, the same rules for financial aid Section 529 Plans described in Section VIII.B apply for Coverdell ESAs.

C. *Gift Tax*

Section 530(d)(3) states, "Rules similar to the rules of paragraphs (2), (4), and (5) of section 529(c) shall apply"²²¹ Section 529(c)(2) and 529(c)(5) govern the gift taxation of Section 529 Plans. Conse-

215. *Id.* § 530(c)(1)–(2) (phasing out the contribution limit for contributors with modified adjusted gross incomes between \$95,000 and \$110,000 (\$190,000 and \$220,000 for joint returns)).

216. *Id.* § 530(b)(1)(A)(ii). The prohibition on contributions after the beneficiary attains age eighteen "shall not apply to any designated beneficiary with special needs (as determined under regulations prescribed by the Secretary)." *Id.* § 530(b)(1) (flush language). However, the Treasury has not promulgated such regulations.

217. *Id.* § 530(b)(1)(E). The age-thirty distribution requirement "shall not apply to any designated beneficiary with special needs (as determined under regulations prescribed by the Secretary)." *Id.* § 530(b)(1) (flush language). However, the Treasury has not promulgated such regulations.

218. *Id.* § 530(b)(2)–(3).

219. *Id.* § 530(d)(5).

220. 20 U.S.C. § 1087vv(f)(5) (2012).

221. I.R.C. § 530(d)(3).

quently, the gift taxation rules for Section 529 Plans, described in Section VIII.C apply for Coverdell ESAs.

D. *Estate Tax*

Section 530(d)(3) states, “Rules similar to the rules of paragraphs (2), (4), and (5) of section 529(c) shall apply”²²² Section 529(c)(4) governs the estate taxation of Section 529 Plans. Consequently, the estate taxation rules for Section 529 Plans, described in Section VIII.D apply for Coverdell ESAs. However, the 2008 Notice does not expressly address Coverdell ESAs.

E. *GST Tax*

Section 530(d)(3) states, “Rules similar to the rules of paragraphs (2), (4), and (5) of section 529(c) shall apply”²²³ Section 529(c)(5) governs the GST taxation of Section 529 Plans. Consequently, the GST taxation rules for Section 529 Plans, described in Section VIII.E apply for Coverdell ESAs.

F. *Creditor Protection*

Like with Section 529 Plans, federal bankruptcy law protects Coverdell ESAs (with some limitations) by removing those assets from the bankruptcy estate.²²⁴ State creditor protection for Coverdell ESAs is state-specific.²²⁵

G. *Use*

The only qualified use for a Coverdell ESA is to pay qualified education expenses. In that case, there is the great benefit of income tax elimination. Any other use generates income tax liability and a 10% penalty, unless some exception to the penalty applies.

H. *Changes in Beneficiary*

The account owner retains near-unlimited rights to change the beneficiary of a Coverdell ESA; the only significant nontax limit is the requirement that such a plan have only one designated beneficiary at a time. As noted earlier regarding taxation, changes in beneficiary in which the new and old are not within the same family give rise to

222. *Id.*

223. *Id.*

224. 11 U.S.C. § 541(b) (2012).

225. For example, Florida law expressly protects Coverdell ESAs. FLA. STAT. ANN. § 222.22(3) (West 2015); *see also* CONN. GEN. STAT. ANN. § 52-321a (West 2015); IND. CODE ANN. § 34-55-10-2 (West 2012); MICH. COMP. LAWS ANN. § 600.6023 (West 2013); N.J. STAT. ANN. § 25:2-1 (West 2001); OHIO REV. CODE ANN. § 2329.66(A)(10)(c)(iii) (West 2017); 42 PA. STAT. AND CONS. STAT. ANN. § 8124(b)(1)(ix) (West 2001); WASH. REV. CODE ANN. § 6.15.010(1)(e) (West 2012).

significant tax consequences. However, changes within the same family do not, as long as the new and old are within the same generation assignment for GST tax purposes, and the new beneficiary has not attained the age of thirty.

I. *Other*

Coverdell ESAs require little preparation and have low ongoing costs—the plan documents are created by the plan sponsor. A reasonably competitive market exists to keep operating costs low. Contributions must be in cash, and investment limits do not exist, except that investments in “life insurance contracts” are prohibited.²²⁶

Contributions are not permitted after the designated beneficiary has reached age eighteen, unless the beneficiary has special needs.²²⁷ The maximum contribution is \$2,000 per year,²²⁸ and that limit phases out for contributors with modified adjusted gross incomes between \$95,000 and \$110,000 (\$190,000 and \$220,000 for joint returns).²²⁹ Interpretation of the \$2,000 limit is not free from doubt. The statute states that “[n]o contribution will be accepted . . . if such contribution would result in *aggregate contributions* for the taxable year exceeding \$2,000.”²³⁰ *Aggregate contributions* is not defined. However, the Service, in its publications, apparently interprets the limit to apply twice: (1) limiting contributors to \$2,000 per beneficiary per year and (2) limiting beneficiaries to \$2,000 per year for all contributions by all contributors.²³¹

The entire balance in the Coverdell ESA must be distributed within thirty days of the beneficiary’s death or turning thirty, whichever comes earlier.²³² However, the age-thirty-or-death distribution requirement can be avoided by a rollover to a Section 529 Plan for the beneficiary²³³ or by a rollover to a Coverdell ESA for a new beneficiary who is in the same family as the former beneficiary and has not attained age thirty.²³⁴ However, in the latter case, the age-thirty-or-death distribution requirement would continue to apply to the new beneficiary of the Coverdell ESA.²³⁵

226. I.R.C. § 530(b)(1)(C).

227. *Id.* § 530(b)(1)(A)(ii); *id.* § 530(b)(1) (flush language).

228. *Id.* § 530(b)(1)(A)(iii).

229. *Id.* § 530(c)(1)–(2). These amounts are *not* indexed for inflation.

230. *Id.* § 530(b)(1)(A)(iii) (emphasis added).

231. TAX BENEFITS FOR EDUCATION, *supra* note 154, at 48.

232. I.R.C. § 530(b)(1)(E). The age-thirty distribution requirement “shall not apply to any designated beneficiary with special needs (as determined under regulations prescribed by the Secretary).” *Id.* § 530(b)(1) (flush language). However, the Treasury has not promulgated such regulations.

233. *Id.* § 530(b)(2)(B) (including within “qualified education expenses” any “contribution to a qualified tuition program (as defined in section 529(b)) on behalf of the designated beneficiary”).

234. *Id.* § 530(d)(5).

235. *Id.* § 530(b)(1)(E).

X. THREE PLANNING PROPOSALS

As shown, there are myriad ways to save for higher education. We now propose default planning approaches for three socio-economic statuses: (1) affluent households, (2) middle-class households, and (3) lower-income households.

A. *The “Affluent” Household*

Consider, for example, a household with \$250,000 (or more) combined annual income.²³⁶ We refer to this as a “can endow” household, meaning that it can, with proper planning, dedicate funds exclusively to education savings while still maintaining other savings priorities (e.g., emergency savings and robust retirement savings). Importantly, because of the household income level, neither financial aid nor education credits will be available to the parents. Therefore, the planning issues themselves become the restrictions on the funds, and, due to the occupations likely involved, creditor protection.

For “can endow” households, the Section 529 Plan is the optimal savings vehicle if the parents are comfortable dedicating those funds to education purposes. The parents can have the funds grow tax-free, satisfy parental funding obligations, and have those funds largely immune from creditor claims.

If, on the other hand, the parents are not comfortable with the use restrictions of a Section 529 Plan, similar results—that is, creditor protection and (some) income tax benefit—can be achieved by using a *Crummey* trust. In this case, investment selection is of paramount importance because there is no statutory tax benefit; therefore, tax-managed investments must be used to minimize the annual tax cost. Also, the pure savings approach could be used—again, with tax-managed investments. In this circumstance, account titling is important to optimize creditor protection (e.g., using tenants-by-entirety ownership).²³⁷

B. *The “Middle-Class” Household*

Consider, now, the typical middle-class household with a combined annual household income of \$50,000 to \$250,000.²³⁸ The conventional wisdom—and, indeed, the marketing campaigns—tout the Section 529 Plans as a universal financial necessity. However, that may not be the case.

236. Importantly, we are not being dogmatic with income brackets or categories here. We are merely trying to show—admittedly with broad strokes—how education savings planning changes (or at least should change) based on a household’s ability to endow education savings.

237. Virginia permits a married couple to transfer property held by them as tenants by the entirety to a trust and retain “the same immunity from the claims of their separate creditors as it would if it had remained a tenancy by the entirety.” VA. CODE ANN. § 55-20.2(C) (West 2017).

238. See *supra* note 236.

We argue that the inflexibility and restrictions of the Section 529 Plan do not outweigh its benefits. Section 529 funds must be used for qualified higher education expenses to avoid penalty. However, many families experience financial emergencies that require major cash outlays (for example, medical issues, major repairs, or the loss of a job—just to name a few). Further compounding the issue is that families in this income bracket may not be able to split savings between the other important non-education savings priorities (e.g., emergency savings and retirement savings) and education savings. While it is possible to contribute to all of the above, will those contributions be sufficient when split so many ways for a family to be able to still fund living expenses? Naturally, the retort to this planning approach—eschewing the Section 529 Plan for middle class households—is to “consider the section 529 benefits.” However, we argue that many of the section 529 benefits can be replicated (or nearly so) while still maintaining fund flexibility.

Consider creditor protection: Yes, Section 529 Plans have statutory protections, but so do tenants-by-entirety accounts and IRAs (which can be another vehicle for the “pure savings” approach). Creditor protection, then, does not sufficiently differentiate Section 529 Plans and other savings approaches.

Consider the income tax exclusion: Yes, Section 529 Plan funds can grow tax-free, but only if ultimately used for education uses. That is the flexibility tradeoff we are weighing. Also, smart fund selection—again, using tax-advantaged funds—can minimize the period tax cost of the investments. Moreover, upon disposition of the funds, families in these income levels are likely privy to the preferential long-term capital gain rates. Finally, the other income tax benefits for education—such as credits and deductions—further reduce the net education cost. The only true loss is the state income tax deduction, if there is any. But, at least for some families and risk tolerances, that tradeoff may be worth the extra flexibility those funds now have.

To summarize, the only true costs of not choosing a Section 529 Plan are the annual income tax exclusion on growth (which can be minimized) and the annual state income tax deduction (if any). Those costs need to be weighed against the added fund use and flexibility benefits provided by not placing those funds in a Section 529 Plan. In effect, the saver in avoiding a Section 529 Plan pays a control premium—in the amount of the lost tax benefits—for retained control over the use of the funds.

C. *The “Lower-Income” Household*

These households have marginal savings ability because of the need to fund current expenditures (food, housing, transportation, etc.). That is, there may be little, if any, free cash flow to irrevocably dedicate to savings. Because of the tax brackets involved, there is little tax

benefit to a Section 529 Plan for these households—that is, those funds and growth are already minimally taxed. Again, the creditor protection can be largely replicated via tenants-by-entirety accounts. In these cases, though, the financial aid rules (particularly for need-based aid) become incredibly important (i.e., how the inclusion and valuation of a Section 529 Plan affects aid eligibility). Nevertheless, we argue that a Section 529 Plan here can still have benefit, namely a psychic benefit. In other words, funding a Section 529 Plan can have positive psychological effects that further promote saving and planning. Indeed, there can also be important parental satisfaction derived from placing funds aside for a child’s education. However, the family needs to be cognizant of other (and perhaps timelier) needs, such as emergency savings and retirement savings.

XI. CONCLUSION

As the chart below notes, Section 529 Plans are essentially exempt from income tax and from all the federal transfer, gift, GST, and estate taxes upon initial contribution. Thus, taxpayers subject to those taxes have powerful incentives to use Section 529 Plans as higher education savings vehicles. However, taxpayers not subject to those taxes have no such incentives. For them, a Section 529 Plan is not optimal because savings within them are committed to funding higher education. Few individuals become liable to pay transfer taxes (although all taxpayers are responsible for figuring out whether such liability arises, for maintaining records, and for filing the necessary documents to perfect exemptions), so that aspect of Section 529 Plans, while complicated to determine, is relatively unimportant. Income taxes affect more individuals, but not all.

The three socio-economic statuses in our case studies demonstrate the relative attractiveness of Section 529 Plans. Lower-income households do not face liability for transfer taxes nor do they face significant liability for income taxes. Thus, for them, Section 529 Plans are not a good idea, because such savings are dedicated exclusively to higher education. Section 529 Plans are only a good idea to the extent that Section 529 Plans creates savings that otherwise would not occur. For affluent households, Section 529 Plans are fabulous. Those households face liability for transfer taxes, face significant liability for income tax, and can easily accept the limitation to higher education spending, which they are likely to do anyway. In the middle are the middle-class households. For them, transfer tax liability is unlikely, but income tax liability is significant. Yet significant as well is the limitation to higher educational use. Middle-class households likely will save and incur higher education expenses, but it is not clear that having dedicated educational savings is optimal for them. Members of those households will have to make the tradeoff between income tax immunity and constrained use, on the one hand, and unconstrained

use and other income tax advantages when higher education expenses actually are paid, on the other.

So, Section 529 Plans are great for affluent households, largely unimportant for lower-income households, and not necessarily optimal for middle-class households. However, for all households, the rules—especially for Section 529 Plans and for the financial aid consequences of all strategies—are complex. The Authors hope to have presented them in a fashion that permits individuals and their advisors to choose among the alternatives.

COMPARISON OF EDUCATION SAVING ALTERNATIVES

Technique	Income Tax	Fin Aid Asset	Fin Aid "Untaxed Income"	Gift Tax on Contribution	Estate Tax for Donor	Estate Tax for Beneficiary	GST on Contribution	Creditor Rights	Use/ Penalty	Change Beneficiary	Other
Pure Savings	Parent	Parent	No	AE and Med/Ed	Yes 2033	0	0 2642(c)	Parent asset	Any	Yes	
UTMA	Child & Kiddie Tax	Child	No	AE	0	Yes 2033	0 2642(c)	Child asset	Any	No	Age 21
2503(c) Trust	Trust at very high rates	Child	No	AE	0	Yes 2033	0 2642(c)	None, if spend-thrift	Any	No	Age 21; but POA
2503(c) <i>Crummey</i> Trust	Trust at very high rates	None	Yes, of child	AE	0	0	Yes	None, if spend-thrift	Any	Yes	Sep. shares eliminate GST
529	0 529(c)(1)	Parent	No	529(c)(2)(A) creates AE; 529(c)(2)(B) AE times 5	0 unless 5 yr	Yes: '98 regs; No: '08 Notice	0 2642(c)	None, if bankruptcy	Educ**/ 10%	Within family; potential Gift & GST	
Coverdell ESA	0 530(a), (d)(2)	Parent	No	Same as 529 530(d)(3)	Same as 529	Same as 529	Same as 529	Same as 529	Educ incl elem & 2dary/ 10%	Same as 529	\$2k annual limit; MAGI phase out

*This Chart assumes child is a dependent student; and the Parent contributes funds, except for GST where Grandparent contributes.

** Educ includes up to \$10,000 per beneficiary for elementary and secondary tuition.

Fin Aid = financial aid; GST = generation skipping transfer tax; AE = annual exclusion of § 2503(b); Med/ED = exclusion of § 2503(e); Kiddie = kiddie tax of § 1(g); POA = power of appointment; MAGI = modified adjusted gross income

