School's Out – But Only For The Summer!: How To Minimize Taxes When Funding Education Expenses

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The following article was featured in the June 2019 edition of *Legacy*, the Vorys newsletter focused on wealth planning.

Whether you're planning early for your child's future or contemplating how your youngest grandchild's education will be covered after you're gone, there are several tax-favorable mechanisms for funding growing education expenses. Below are a few options for covering the costs of school – from private elementary school tuition to college room and board – while minimizing income, gift, and generation-skipping transfer taxes.

529 PLAN

What is it? A "qualified tuition plan," more commonly known as a "529 plan," is a tax-advantaged investment account that offers a way to save for future education expenses. 529 accounts must be established for a single individual beneficiary. All contributions made to the investment account can continuously grow tax-free, and withdrawals are not subject to federal income tax as long as the withdrawn funds are used for "qualified higher education expenses."

How should I fund it? Any transfers to the account will be removed from the donor's gross estate, but will be considered gifts to the account beneficiary. The donor can use annual exclusion gifts ($15,000 per person or $30,000 for spousal split gifts) to transfer assets into the account without incurring gift tax liability. The tax code also permits a donor to treat the gift as if it were made over a 5-year period, thereby allowing the donor to shelter a larger contribution by utilizing gift tax annual exclusions available for future years.

How can the funds be used? One major advantage of the 529 plan is that "qualified education expenses" encompass a much broader range of costs than many other options. In addition to college tuition, funds can be used to pay for private primary and secondary schools, books and fees, and room and board for students who are at least half-time students.

What if the beneficiary doesn't use all the funds? Withdrawals from the account that are not used for qualified education expenses are subject to income taxes and penalties. As an alternative, the account may be rolled over into another 529 plan for a family member of the beneficiary, such as a spouse, sibling or child.

Other Considerations. Keep in mind that almost every state offers its own 529 plan, and you can fund a plan in any state. Each state sets is own minimum and maximum contribution amounts, offers its own investment options, and sets the applicable fees. Some states also offer additional state income tax benefits. For example, Ohio offers up to $4,000 of income tax deductions per beneficiary, per year, for contributions to an Ohio CollegeAdvantage 529 plan. Ohio also permits an unlimited carry forward of such deductions.

GIFT TAX EXCLUSION FOR CERTAIN EDUCATION EXPENSES

What is it? Any tuition paid directly to "educational organizations" will not be treated as a gift for gift tax purposes.

How can the funds be used? The exclusion is limited only to tuition payments.

How should I fund it? The tuition payment must be made directly to the educational organization.

Other considerations. Since the payment is not treated as a gift, you'll still have annual exclusion available to assist the beneficiary with books, fees, room and board, and other related expenses, if desired. Any available funds in a 529 plan can also be used to pay for such other education-related expenses. Note that the same exclusion applies to medical expenses paid directly to a medical provider.

HEALTH AND EDUCATION EXCLUSION TRUST (HEET)

What is it? The primary purpose of a Health and Education Exclusion Trust or "HEET" is to provide for tuition payments to an educational organization (or medical expenses to a medical provider) for the benefit of a beneficiary.

How can the funds be used? Distributions for the beneficiary or beneficiaries should be limited to tuition payments (or payments of medical expenses) consistent with the gift tax exclusion described above.

How should I fund it? Although the distributions from the trust are not subject to gift tax, contributions to the trust are considered taxable gifts. The trust could be funded using the annual exclusion amount or using more creative funding plans, such as a grantor retained annuity trust (GRAT).

Other considerations. In addition to more robust investment options than a 529 plan, the major benefit of a HEET is that all distributions consistent with the applicable purpose (either tuition payments or medical payments) will not be subject to gift or generation-skipping transfer tax. This is particularly advantageous for grandparents. A trust can be created for one or more grandchildren and will continue paying such grandchild(ren)'s tuition and medical expenses even once the grandparent has passed away.

Note that if only grandchildren or other “skip persons” are beneficiaries of the trust, gifts to the trust will also be immediately subject to generation-skipping transfer tax. To avoid this, the trust must include a current beneficiary who is a “non-skip person.” However, there are a number options you can discuss with your attorney to resolve this issue.

Keep in mind that although these options have significant tax benefits, they could affect the student’s eligibility for financial aid. In addition, certain education-based tax credits may not be available.

Contact your Vorys attorney to discuss the education funding plan that best fits the financial situation of your family.