

THE GST IN EDUCATION PLANNING: GIVE SOME THOUGHT

I am a tax lawyer, not a clinical psychologist. However, there is evidence out there that suggests that having grandchildren makes a person happier. As the father of a five-year old boy, I've witnessed the positive effect that he has on my parents and in-laws. Here's another thing that I've observed firsthand in my family and from my former days in private practice as a trusts & estates attorney: grandparents get this immediate urge to do something big for that newborn grandchild. I'm not talking about buying a double jogging stroller. I mean opening and funding a 529 college savings plan or creating a trust, as if one's inclusion in the grandparent club depended upon it.

As I sat down to write this *Wealth Planning Insights* article, I began with a Google search for quotes about grandchildren. In doing so, I came across a nutty quote involving walnut trees and grandchildren. This quote, allegedly attributable to George Orwell, states: "A thing which I regret, and which I will try to remedy some time, is that I have never in my life planted a walnut. Nobody does plant them nowadays — when you see a walnut it is almost invariably an old tree. If you plant a walnut you are planting it for your grandchildren, and who cares a damn for his grandchildren?" Well, if Orwell truly uttered this statement, he obviously did so at a time when the cost of a college education was peanuts (or walnuts) compared to today's costs. In order to combat the soaring cost of a college education, many grandparents now feel it is their duty to assist their own children by helping save for a grandchild's education. And it is often the case that during this new phase in life, as one's family expands to make room for another generation, where one first encounters a lesser-known wealth transfer tax called the generation-skipping transfer ("GST") tax.

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Now the GST tax doesn't just apply to transfers made by grandparents. Yet, the classic example of a generation-skipping transfer often involves a grandparent's transfer to a grandchild. This is known as a "direct skip." So when a grandparent contributes money to a 529 college savings plan for a grandchild, that transfer of property bypasses the grandparent's child (the parent of the grandchild) occupying the generation immediately below the grandparent. But the GST tax applies to transfers made by any individual that skips a generation, regardless of whether one has any lineal descendants. So those of you without grandchildren, grandnieces, or grandnephews cannot completely dismiss the GST tax. You might have significantly younger friends — or a significantly younger significant other — that you want to support financially. Those gifts may also be generation-skipping transfers. And if you don't plan on making any transfers that skip a generation, you or someone you love may be on the receiving end of a transfer from someone "higher-up." In that case, you'll want to be aware of the potential GST issues associated with that transfer (disclaimer: having this information won't guarantee that you will receive more).

The last major tax reform our country has seen occurred in 1986 — over thirty years ago. Our current Congress has a full plate of issues to resolve, many of which they just can't seem to agree on. It is possible that a child born today could graduate from college before significant changes to our tax code occur, particularly in the areas of estate, gift, and GST tax. Planning for education will always be relevant, and the wealth transfer tax issues involved in that planning process just may be here to stay. Therefore, before you start making those gifts to those special (possibly skip) people in your life, here are answers to three common GST questions you'll be glad I didn't skip.

ARE ALL TRANSFERS TO OR ON BEHALF OF A SKIP PERSON SUBJECT TO GST TAX?

The GST tax only applies to transfers to skip persons.¹ The first step to tackling this tax lies in determining whether the person on the receiving end of your generosity is a skip person. A person related to you by blood or marriage is a skip person if that individual's generational assignment is two or more generations below yours.² Spouses are deemed to occupy the same generation, regardless of age difference, so the GST tax never applies on transfers between spouses (both current and former).³ But that age difference will be relevant for tax purposes prior to marriage, since that significant other is considered a non-relative at that stage of the relationship. Non-relatives who are more than 37½ years younger than you are also skip persons.⁴ Lastly, a trust is a skip person if the current beneficiary is a skip person.⁵ So a trust created for a grandchild is a skip person, as is a 529 college savings plan, since these types of accounts are also considered trusts for GST purposes.⁶ Anyone who is not a skip person is automatically a non-skip person.⁷ Transfers to non-skip persons will be subject to gift or estate tax (depending on the timing of the transfer), but are never subject to GST tax.

Explaining the GST Tax

The classic example of a generation skipping transfer often involves a grandparent's transfer to a grandchild, which is known as a "direct skip." But the GST tax applies to transfers made by any individual that skips a generation, regardless of whether one has any lineal descendants.

The first step to tackling this tax lies in determining whether the person on the receiving end of your generosity is a skip person. A skip person is any of the following:

- If a relative's generational assignment is two or more generations below yours; or
- Non-relatives who are more than 37½ years younger than you; or
- A trust or 529 Savings Plan, if the current beneficiary is a skip person.

James Thurber is quoted as saying that “there is no exception to the rule that every rule has an exception.” The GST tax applies to transfers made to or on behalf of skip persons. This is the general rule. Yet not one, but two, exceptions may apply to prevent a generation-skipping transfer from occurring on certain transfers.

Not to be pedantic, but what we are really talking about are exclusions rather than exceptions. The first exclusion is the medical and education expense exclusion. Internal Revenue Code §2503(e) discusses certain “qualified transfers” which are considered nontaxable gifts. Qualified transfers, for purposes of §2503(e), include payments for tuition (and only tuition) and medical care. So long as these payments are made directly to the educational or medical care provider, they are not considered gifts. The relationship and age of the individual on whose behalf the transfer is made is irrelevant. Since these qualified transfers are nontaxable gifts, they also are nontaxable for GST tax purposes.⁸ When it comes to making qualified payments for the education of another, one is not limited to higher education (as is the case with a 529 college savings plan, as the name suggests).⁹ So the private school tuition for that grandchild in kindergarten or high school will qualify for the education exclusion just like college tuition, so long as the payment is made directly to the education provider.

One cannot survive on tuition alone. The cost of education will also include one or more of the following expenses: room and board, books, computers, supplies, travel, and miscellaneous administrative fees. While the education exclusion does not apply to any of these add-ons, there is a second exclusion available that can be used to offset some or all of these education related expenses. This second exclusion is known as the annual exclusion for gifts, found under Internal Revenue Code §2503(b). The annual exclusion for gifts represents the nontaxable amount of a transfer to an individual. Currently \$14,000, the annual exclusion for gifts is indexed for inflation (the amount has been stuck at \$14,000 for the last three years). The gift tax annual exclusion can also be combined between spouses, so collectively a married couple can transfer \$28,000 to as many individuals as they choose within a calendar year.¹⁰ Any amount exceeding the first \$14,000 or \$28,000 (in the case of a spousal split gift election) in a calendar year will be a taxable gift.

In order for a transfer to qualify for the annual exclusion, the recipient must have a “present interest” in the gifted property. This is easy to accomplish when you make a gift directly to a person — theoretically the property is theirs to do what they want with it (and if you don’t approve, then you can turn off the gift faucet, so to speak). Gifts to 529 college savings plans are deemed to satisfy the present interest requirement.¹¹ But remember that a gift to a 529 college savings plan does not count as a qualified education payment for purpose of the education exclusion.¹² Therefore, you will have to use your annual exclusion for gifts to cover transfers to 529 college savings plans. However, keep in mind that

There are two exclusions to the GST Tax

- Medical and education expense exclusion (e.g. payments for tuition and medical care being made directly to the educational or medical care provider); and
- The GST annual exclusion (individuals may gift up to \$14,000 per person, per calendar year, or \$28,000 per person, per calendar year for married couples splitting gifts).

you can take advantage of both exclusions. A grandparent can pay the private pre-school tuition for a grandchild directly to the education provider and contribute \$14,000 to a 529 college savings plan for that grandchild in the same year.

If you don't think that one (or a combined) annual exclusion per year will be enough to start chipping away at the looming cost of college education, there is a way for you to "quintuple down" on your gift and get compounding investments to start working for you sooner than later. The second question and answer (Q & A) discussed below addresses the concept of "frontloading" a 529 college savings plan. The GST tax also has its own annual exclusion, tied to the same amount as the annual exclusion for gifts.¹³ But don't assume that all transfers qualifying for the annual exclusion for gifts also qualify for the GST annual exclusion. This is certainly the case for transfers made directly to an individual, as well as those made to a 529 college savings plan.¹⁴ However, it would be a big mistake to assume the rules are the same with respect to transfers to trusts. So if you are thinking about creating a trust for a grandchild or some other skip person, don't start transferring like its 1988 (when the rule changed with respect to qualifying transfers to trusts for the GST annual exclusion). And don't be fooled by the fact that the amounts of the annual exclusions for gift and GST purposes are the same. Even though each moves lockstep with the other as the amounts adjust for inflation, their paths diverge when a transfer to a trust occurs. But don't fret, since the last Q & A discussed below provides you with a roadmap for making transfers to trusts that qualify for the GST annual exclusion.

WHAT ARE THE GIFT AND GST TAX ISSUES ASSOCIATED WITH FRONTLOADING A 529 COLLEGE SAVINGS PLAN?

Frontloading is the term used to describe the process of funding a 529 college savings plan in a single year with an amount equal to five times the current annual exclusion amount. In 2017, individuals can contribute \$70,000 to a 529 college savings plan (or \$140,000 if spouses elect to split gifts) and not have to pay any gift or GST taxes on the transfer. This is because the IRS allows individuals to essentially use five years' worth of annual exclusions all at once.¹⁵ After making an election on IRS Form 709, the Federal Gift (and Generation-Skipping Transfer Tax) Return, the IRS will allow a portion of the initial gift to be treated as having been made ratably over a five year period. The key is to affirmatively make the election on Form 709 for the calendar year of the initial contribution. A statement will also need to be attached to this same Form 709. The statement should describe the total amount transferred to the 529 college savings plan, the amount for which the election is being made, and the name of the individual for whose benefit the account has been created.¹⁶

Even though the frontload election is limited to \$70,000 per person in 2017, this doesn't mean that you can't contribute more than this amount in a calendar year to the 529 college savings plan. For estate and gift tax purposes, taxpayers receive a basic exclusion amount that is separate from the annual exclusion

In 2017, individuals can contribute \$70,000 to a 529 college savings plan (or \$140,000 if spouses elect to split gifts) and not have to pay any gift or GST taxes on the transfer if the election to frontload is made on a gift tax return.

for gifts.¹⁷ The basic exclusion effectively works to offset taxable transfers made during lifetime or upon death with the assistance of its partner-in-tax, the applicable credit amount. The current basic exclusion amount is \$5,490,000. The GST tax has something similar, known as the GST exemption amount.¹⁸ It too is currently \$5,490,000 in 2017 (both amounts were initially set at \$5,000,000 and are indexed for inflation after 2011 pursuant to the Taxpayer Relief Act of 2012). You can apply your basic exclusion and GST exemption to offset any taxes that would be imposed on any contributions to a 529 college savings plan in an amount greater than \$70,000 in a calendar year (or \$140,000 for spousal split gifts), assuming the election is being made to treat the first \$70,000 as being made ratably over a five-year period.

WHAT IS THE DIFFERENCE BETWEEN THE ANNUAL EXCLUSION FOR GIFTS AND THE GST ANNUAL EXCLUSION WHEN IT COMES TO TRANSFERS TO TRUSTS?

The GST annual exclusion under the Tax Reform Act of 1986 mirrored its gift tax counterpart under Internal Revenue Code §2503(b), which required the recipient of a transfer to possess a present interest in the property. But things changed after March 31, 1988. For transfers to trusts occurring after March 31, 1988, not only must the beneficiary have a present interest in the property transferred (often accomplished by granting the beneficiary a “Crummey” withdrawal power, which is basically a general power of appointment for a limited period of time), but the trust must also be a vested interest, direct skip trust.¹⁹ In order for a transfer to a trust to qualify for the GST annual exclusion, only one skip person can have a current interest in the trust (for example, a grandchild), and the trust property must vest in the skip beneficiary. Vesting can be accomplished for tax law purposes (by being includible in the skip person’s estate at death due to the possession of a testamentary general power of appointment over the trust property) or property law purposes (with the trust’s assets being distributed to the skip person’s estate at death).²⁰ If either the single skip beneficiary requirement or vesting requirement is not satisfied, then the transfer will not qualify for the GST annual exclusion. However, so long as the beneficiary is given a present interest in the property transferred, the transfer will still qualify for the annual exclusion for gifts.

There are many options when it comes to saving for college. Instead of funding a 529 college savings plan, you may consider creating a trust that would allow the trustee to make distributions for the education of a grandchild, grandniece, grandnephew, or other skip person. If you are counting on using your GST annual exclusion, then you will want to create a separate trust for each skip person. Creating a single trust or “pot trust” to benefit multiple beneficiaries within a class (your grandchildren, for example) will prevent your gifts from being eligible for the GST annual exclusion. Yet this doesn’t mean that you

have to pay a lawyer to create an additional trust each time a new grandchild is born, especially if the trust's terms will be exactly the same for each grandchild. Instead, you can create the separate trusts all under a single trust agreement. One document; multiple trusts; one beneficiary per trust; one fee. I just knew you'd like this last part.

CONCLUSION

Saving for the cost of education is multifaceted. The transfer tax issues associated with planning for another individual's education are complicated, and often go overlooked. After reading this article, you should be poised to give these tax issues some thought. While I touched upon only a few modes for saving and paying for education, the menu of options available to choose from can be vast and overwhelming. Northern Trust Wealth Planning Advisory Services, and in particular, Northern Trust's Wealth Advisors, can provide you with the resources you need to thoughtfully and successfully plan for a loved one's education.

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¹ IRC §2612

² IRC §2651(b)

³ IRC §2651(c)(1)

⁴ IRC §2651(d)

⁵ IRC §2613(a)(2)

⁶ IRC §2652(b)(1)

⁷ IRC §2613(b)

⁸ IRC §2611(b)(1)

⁹ IRC §529(e)(5)

¹⁰ IRC §2513

¹¹ IRC §529(c)(2)

¹² IRC §529(c)(2)(A)(ii)

¹³ IRC §2642(c)(3)(A)

¹⁴ IRC §529(c)(2)

¹⁵ IRC §529(c)(2)(B)

¹⁶ Instructions to IRS Form 709

¹⁷ IRC §2010(c)(3)

¹⁸ IRC §2631

¹⁹ Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647)

²⁰ IRC §2642(c)(2)

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