Published on *The National Law Review* https://natlawreview.com

How Can You Help Pay for Your Student's Education?

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Due to the rising costs of education, many Americans are looking for ways to fund the educational expenses of their children and grandchildren.

In 2023, Congress overhauled the Free Application for Federal Student Aid ("FAFSA") and the Department of Education's process for awarding federal student aid, which has taken effect for the 2024–25 award year. These changes included a simplified form, removal of the sibling discount, introduction of a new eligibility formula, modified family and aid considerations, and expanded access to Pell Grants. These changes are aimed at better aligning federal aid with the actual cost of college. Even with these changes, however, additional funding may be necessary to fully cover the costs.

For family or friends interested in gifting funds to assist with education, it is important to understand the options for structuring these gifts and the tax and other implications for each option. Each year every individual can make a tax-free gift of up to $18,000 (the "annual exclusion" which increased in 2024 from $17,000). To qualify for the annual exclusion, the beneficiary must have an immediate right to the use of the gift, what's called a "present interest". This can be a challenge when planning for minors or young adults who may need more structure around gifts due to age or financial maturity, a challenge that can be met via various techniques. Below is a brief summary of some of the most useful and popular mechanisms available to help pay for the high cost of education.

Direct Payment of Tuition

Tuition payments made directly to an educational organization are not taxable gifts ("Tuition Exclusion"). A gift tax return is not even required to be filed for amounts passing under the Tuition Exclusion. Paying tuition directly is therefore the most efficient way to make gifts to children and grandchildren. The Tuition Exclusion only applies to tuition and does not extend to books, supplies, room/board or other such expenses. Primary, secondary, preparatory schools, colleges, and universities are all considered "educational organizations."

Unfortunately, paying for a student's tuition will reduce the student's eligibility for need-based financial aid both with the educational organization and with the FAFSA.

529 Plans

529 Plans are tax-advantaged education savings plans sponsored by individual states and are structured as Prepaid Tuition Plans or 529 Savings Plans. 529 accounts are easy to establish and contributions to them qualify for the gift tax annual exclusion even though the funds are not actually held by the beneficiary. An account owner may have multiple different 529 accounts, but each account may only have one beneficiary. So, for example, parents can set up a separate 529 account for each of their children. Wisconsin limits total contributions to a 529 Plan to $567,500 and these accounts can only receive cash. A 529 plan owned by the student or their parent is considered a parent's asset on the FAFSA and will affect aid eligibility, while a grandparent-owned plan will not affect the student's aid eligibility.

With 529 Savings Plans, the funds accumulate on a tax-deferred basis and distributions for qualified expenses are tax-free. The definition of qualified college expenses has expanded over time and generally includes tuition, fees, room, board, textbooks and computers. 529 Savings Plans provide more flexibility than Prepaid Tuition Plans, but also do not "lock in" a guaranteed full payment of tuition. Many states also offer at least one 529 Savings Plan that has no residency restrictions for the listed beneficiary.

If a beneficiary completes their education without fully utilizing the 529 Plan, the account owner has several options to dispose of the remaining funds including changing the beneficiary to another qualifying family member or rolling a limited amount of the remaining funds into a Roth IRA for the beneficiary. The funds can also be withdrawn, however, in that case taxes and penalties may apply.

There is no federal income tax deduction for 529 Plan contributions, but Wisconsin taxpayers can qualify for a state tax deduction ($5,000 per beneficiary for single filers or married filing jointly or $2,500 per beneficiary for married filing separately) each year from contributions made to a 529 Plan.

The IRS has expanded its definition of a 529 Plan owner to allow for an irrevocable trust to own a 529 Plan. One of the benefits of this strategy is that a 529 Plan owned by a trust is not counted on the FAFSA as an asset affecting a student's financial aid eligibility.

Only nine states offer Prepaid Tuition Plans, and Wisconsin is not among them. With Prepaid Tuition Plans, the donor prepays the beneficiary's tuition at current tuition rates and, if the student selects an eligible college or university, the beneficiary's tuition will be fully paid (i.e., the tuition price is "locked in"). If the beneficiary does not select an eligible college or university, the funds may still be used to pay for the beneficiary's tuition, but the beneficiary's tuition will not be "locked in" to guarantee full payment. Prepaid Tuition Plans only cover tuition and do not extend to books, supplies, room, board or other such expenses. Prepaid Tuition Plans also typically require that the donor or the beneficiary be a resident of the state offering the Prepaid Tuition Plan.

Custodial Accounts

Alternatively, a Uniform Transfers to Minors Act Account ("UTMA") or Uniform Gifts to Minors Act Account ("UGMA"), referred to as "Minors Accounts," can be established to accumulate funds for a beneficiary. These accounts are not limited to education, like 529 plans, but payment of education expenses is certainly permitted. Any number of donors may contribute to a Minor's Account. Contributions qualify for the gift tax annual exclusion despite the funds being managed by the custodian rather than the beneficiary. UTMA accounts may be funded with any type of property (cash, real estate, tangible personal property, etc.) and UGMA accounts may be funded with any type of financial asset (cash, securities, annuities, insurance policies, etc.).

Prior to the beneficiary reaching the age of majority (age 21 in Wisconsin), the listed account custodian is in charge of determining how the funds are used. After the beneficiary reaches the age of majority, the remaining funds must be distributed outright to the beneficiary.

An UTMA or UGMA account is deemed to be owned by the beneficiary and the beneficiary will have income tax obligations if the income of the Minors Account is above the filing limits.

2503(c) Minor's Trust

Another option for funding is to create a stand-alone trust for the beneficiary. Trusts provide maximum flexibility in terms of investment, distributions, and asset protection. One type of trust that can be a useful tool to fund educational expenses is referred to as a Section 2503(c) Minor's Trust ("Minor's Trust"). This is a trust established to hold gifts made to a beneficiary who is under age 21. Gifts to a Minor's Trust qualify for the gift tax annual exclusion. The trustee has full discretion to use the trust assets for the benefit of the beneficiary. The beneficiary must have the right to withdraw the trust assets upon reaching age 21 and, provided that the beneficiary does not exercise such withdrawal power, the trust assets may continue to be held in trust for the benefit of the beneficiary after age 21. If the beneficiary dies before reaching age 21, the remaining trust assets must be distributed to the beneficiary's estate.

The Minor's Trust will count as assets of the beneficiary for purposes of the FAFSA.

The Minor's Trust is a separate taxpayer for income tax purposes and the Trust will be responsible for paying tax on any income that is not distributed to the beneficiary. Trusts generally have less favorable income tax treatment than individuals.

Estate and Gift Tax Exclusions and Exemptions

2024 Gift tax exclusion. The amount that can be transferred annually to any individual without any gift tax consequence (and without using your lifetime exemption described below) has been raised from $17,000 to $18,000 for 2024. Remember, this is the gift tax annual exclusion for present interest gifts only. The exclusion will not apply to a gift of a future interest, so only some gifts to trusts qualify for the exclusion. Be sure to give us a call if you have questions.

Estate/Gift Tax Exemption. The value of property that can be transferred by gift or at death without tax (the lifetime exemption) adjusts with inflation. After the inflation adjustment, the lifetime exemption for an individual for gifts made during 2024 or deaths occurring in 2024 is $13,610,000. Married couples can now assume each other's unused exemption so that a married couple can effectively transfer over $27 million without gift or estate tax. Transfers to spouses and charities continue to be free of tax (and will not use your lifetime exemption) as long as the transfers qualify for the gift or estate tax marital or charitable deduction. There are specific rules for gifts to a noncitizen spouse and noncash gifts to charities that we can help you navigate. **WARNING:** Remember, the increased exemption is scheduled to expire on December 31, 2025, when it reverts to the levels before the Tax Cuts and Jobs Act which, with an inflation adjustment, may be expected to be between $6.5 and $7 million per person or $13-14 million for a married couple. Of course, Congress could make other changes prior to that date. If you are interested in using the high exemptions currently available before they expire, we can discuss ways to accomplish that.

Biden Tax Proposals. President Biden has also proposed additional modifications to the gift and estate tax exemptions. Biden's proposals would remove the requirement that the gift tax annual

exclusion apply only to gifts of a present interest, but would then limit the annual tax-free gifts per donor to $50,000 (or $100,000 for a married couple). Any gifts in excess of the new limits would use the lifetime exemption. Biden has also proposed making the transfer of appreciated property through gifts during lifetime or inheritances at death a taxable event for capital gain purposes; provided, however, that such transfers would qualify for the marital or charitable deduction. This would include a $5,000,000 exclusion of the capital gains for single taxpayers or $10,000,000 exclusion for married couples.

National Law Review, Volume XIV, Number 143