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3 KEY STRATEGIES FOR FUNDING EDUCATIONAL EXPENSES

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Clients often ask us how to plan for educational expenses for their children or grandchildren.

According to the College Savings Plans Network, at an inflation rate of 6%, it will cost about \$276,954 to send a child who is currently a toddler to an in-state, public college for four years, inclusive of tuition, fees, room, and board, and about \$633,947 to a private college. Considering the staggering cost of education, it is crucial to plan and explore strategies that can make funding your children's education less burdensome. In this article, we will discuss three key strategies clients can use to fund education: (1) a Section 529 Plan, (2) direct payment of tuition, and (3) trusts.

SECTION 529 EDUCATION SAVINGS PLANS

A Section 529 Plan, also known as a "Qualified Tuition Program" or a "529 plan," is a tax-advantaged savings account designed to be used for a beneficiary's educational expenses. Any U.S. resident can create a 529 plan. There are no income restrictions on 529 plan accounts. The account must be for the benefit of a single beneficiary, usually a child or grandchild. The beneficiary generally does not have to include the earnings from a 529 plan as income. Contributions to the 529 plan are not tax-deductible on federal returns, but interest earned on the account and qualified withdrawals are tax-free if used to pay for qualified higher education expenses. Qualified higher education expenses include an annual tuition expense of \$10,000 per beneficiary for enrollment or attendance in K-12 programs (which can be private, public, or religious). They also include unlimited tuition payments to a college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. Expenses for books, supplies and equipment, computers, and room and board are also included. Amounts can also be withdrawn to pay principal or interest on a designated beneficiary's or their sibling's student loan, which is limited to a lifetime maximum of \$10,000 for any one individual.

Many states offer an additional tax-break for 529 plan contributions. In New York and Connecticut, contributions up to \$5,000 (\$10,000 for married couples filing jointly) are deductible annually from taxable income. Non-qualified withdrawals for purposes other than qualified higher education expenses may incur penalties and federal (and possibly state and local) income tax on any earnings withdrawn.

CONTINUED

3 KEY STRATEGIES FOR FUNDING EDUCATIONAL EXPENSES

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Below are some additional benefits of a 529 plan:

- 1. Control and Estate Planning Benefits:** Although you can gift money to an existing 529 plan account established by another account owner, there are benefits to opening a new account for the same beneficiary for which you or your spouse are the account owner. The account owner has complete control over the amount and frequency of contributions and can manage how the funds are invested.
- 2. Flexibility:** A 529 plan does not have to benefit only relatives; it can be opened for any individual. Additionally, the account owner can change the designated beneficiary to a member of the beneficiary's family at any time without tax consequences. This is important if for example, the initial beneficiary qualifies for a scholarship and has no educational expenses.
- 3. Front-loading and Gift and Estate Planning Benefits:** In 2024, you can front-load a 529 plan by giving up to five years' worth of annual gifts, currently \$18,000 per year, for a total of \$90,000 per beneficiary without incurring gift tax or using part of your lifetime gift tax exclusion. However, this means the donor has used up his or her annual exclusion for that specific donee for the next five years. Additionally, once funds are contributed to the account, they are generally considered to be out of the donor's estate.

Effective January 1, 2024, assets in a 529 plan can be rolled over to a Roth IRA without federal taxes or penalties as long as the withdrawal meets certain criteria

DIRECT PAYMENT OF TUITION

Another strategy is to make direct payments of tuition to your child's or grandchild's school.

Here are some key benefits:

- 1. Tax Exclusions:** Under section 2503(e) of the Internal Revenue Code, tuition payments made directly to a qualified educational institution on behalf of an individual are not treated as taxable gifts and, under section 2642(c)(3)(B), these tuition payments are also exempt from the generation skipping transfer ("GST") tax. In other words, these payments are not counted towards your annual gift tax exclusion amount (\$18,000 in 2024) and will not use up any of your lifetime gift or GST tax exemption (\$13.61 million in 2024). Therefore, a significant benefit of direct tuition payments is that it maximizes the benefit to your child or grandchild with no tax consequence to you.
- 2. Broad Applicability:** You can pay anyone's tuition, and it can be for any type of qualified educational institution, whether a primary, secondary, or post-secondary (college or university) institution.

CONTINUED

3 KEY STRATEGIES FOR FUNDING EDUCATIONAL EXPENSES

It is important to remember that tuition payments must be made directly to the institution. You cannot reimburse the student for a payment they made themselves. Additionally, payments for expenses such as room, board, and books do not qualify. Furthermore, depending on one's age and health, there could be a risk that one dies prior to the payment of all the tuition bills. It's possible to prepay tuition directly to a school while still not incurring any gift tax or GST tax, but this prepayment must be nonrefundable, even if the student fails to attend or leaves the school.

TRUSTS

Funding a trust for your child's or grandchild's education is another viable strategy. A trust is created by the "Grantor" who funds the trust for the benefit of one or more individual(s) or "Beneficiaries." The Grantor also appoints the Trustee(s) who will be responsible for investing, administering, and distributing the trust assets to the Beneficiary or directly to an institution on the Beneficiary's behalf.

Trusts offer unique benefits that are not provided by the other strategies. Below are some of these benefits:

- 1. Broad Definition of Education Expenses:** Unlike 529 plans or direct payment of tuition, a trust's definition of a qualified education expense can be tailored to the Grantor's preferences.

Example of a Broad Definition: "Education" means primary, elementary, secondary, post-secondary, graduate, or professional schooling in an accredited institution, public or private, or attendance at other formal programs in furtherance of the beneficiary's spiritual, athletic, or artistic education, including but not limited to payments for tuition, books, fees, assessments, equipment, tutoring, transportation, and reasonable living expenses.

Example of a Restrictive Definition: "Education" shall include, without limitation, tuition, room and board, books and supplies, library and laboratory fees, special instruction, and other related expenses incurred during university and post-graduate education.

- 2. Flexibility for Multiple Beneficiaries:** Since a trust can have more than one beneficiary, a single trust can be created to accommodate different levels of educational expenses for multiple beneficiaries. Funds are pooled together and distributions may be made in unequal amounts to the beneficiaries depending on their needs. Later, when all beneficiaries reach a certain age or have completed their education, any remaining funds can be distributed into separate trusts for each beneficiary.
- 3. Creditor Protection:** Trust funds are protected from creditors, offering an additional layer of security not available with 529 plans or direct payment of tuition.

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This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

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- 4. Incentives and Requirements:** Through a trust, the Grantor can establish incentives or specific requirements for beneficiaries to receive distributions. For example, maintaining a specific GPA.
- 5. More Funding and Investment Options:** Unlike 529 plans which can only hold cash, trusts can be funded with a wide array of assets (i.e., cash, stocks and mutual funds) and invested.

SELECTING THE BEST STRATEGY

When choosing the best strategy or the order in which to engage in these strategies, consider the following factors:

- 1. Number of Beneficiaries:** Your strategy may differ depending on whether you have one child/grandchild or multiple children/grandchildren.
- 2. Age of Beneficiaries:** Younger children and grandchildren may have different educational expenses compared to those heading to college soon.
- 3. Timing of Funds:** If the funds are not needed for some time but you want to start saving now, a 529 plan or trust may be the right choice.
- 4. Tax and Estate Planning:** Consider the importance of estate tax planning and income tax planning for your situation.
- 5. Current Estate Plan:** Assess your current estate plan to determine which strategy aligns best with your goals.

It is never too early to start on planning and funding your child's or grandchild's education. The cost of education is significant, but with careful consideration and the right strategies, you can make it a less taxing experience. If you have any questions or need guidance on funding your family's education, please do not hesitate to contact a Wiggin and Dana attorney. We are here to help you navigate this important aspect of your financial and estate planning.