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# Private Clients, Trusts and Estates

*update*



One Atlantic Center  
Suite 2300  
1201 West Peachtree Street  
**Atlanta, GA** 30309  
t 404.437.7000  
f 404.437.7100

6600 Sears Tower  
**Chicago, IL** 60606  
t 312.258.5500  
f 312.258.5600

One Westminster Place  
**Lake Forest, IL** 60045  
t 847.295.9200  
f 847.295.7810

900 Third Avenue  
**New York, NY** 10022  
t 212.753.5000  
f 212.753.5044

One Market  
Spear Street Tower  
32nd Floor  
**San Francisco, CA** 94105  
t 415.901.8700  
f 415.901.8701

1666 K Street, N.W.  
Suite 300  
**Washington, DC** 20006  
t 202.778.6400  
f 202.778.6460

1000 Skokie Blvd.  
Suite 215  
**Wilmette, IL** 60091  
t 847.920.9327  
f 847.920.9329

[www.schiffhardin.com](http://www.schiffhardin.com)

As another school year begins, parents everywhere must focus on how they will find the money to pay for their children's education. Oftentimes, grandparents wish to help their children and grandchildren by paying for the grandchildren's education. In cases where the grandparents may be more affluent, they also may seek ways to reduce their estates for federal and state estate tax purposes and to pass property to their grandchildren in the most tax efficient manner. This newsletter discusses some of the techniques that can be used to make gifts to grandchildren for education as well as for broader purposes.

**Basic Gift Tax Rules.** Each individual may make an unlimited number of so-called *annual exclusion gifts* each year without any gift or estate tax consequences. In 2007, the maximum amount of an annual exclusion gift is \$12,000 per donee. Thus, if Mrs. Jones has three children and seven grandchildren, she could give away \$120,000 each year (\$12,000 to each of 10 descendants) absolutely free of transfer tax. (If Mrs. Jones were married, the two of them can give twice as much, or \$24,000 per year, to each donee free of transfer tax.)

A second category of "free gifts" relates to payments made *directly* to a provider for medical or educational services on behalf of someone else. There is an unlimited exemption for such gifts but care must be taken to make sure that the gift is for a qualifying expense and is made directly to the provider of the service. A payment to a child to reimburse the child for his or her doctor's bill will not qualify, but a *direct* payment to the doctor will (assuming it is for a qualified expense). We will discuss the education exemption in more detail later in this newsletter.

In addition to the \$12,000 annual exclusion gifts and direct gifts for medical and education expenses, each individual also has a \$2 million general exemption for tax-free transfers, and up to \$1 million of that can be used for lifetime gifts. These amounts are aggregate amounts over one's lifetime and are not replenished every year. Thus, if Mrs. Jones also gives her children \$750,000 in addition to the \$120,000 of annual exclusion gifts, she will owe no gift tax at this time, but she will use \$750,000 of her estate tax exemption so that she will be able to pass \$1,250,000 to her children free of estate tax at her death. (It still can be beneficial to make this type of gift because all of the future appreciation on the property that is given away during lifetime will escape estate tax at the donor's

death.) For 2007 through 2009, gifts that are not sheltered from gift tax by the \$12,000 annual exclusion, the medical and educational exemptions or the \$1 million lifetime exemption are subject to a gift tax of up to 45%.

**529 Plans.** Donors can use their \$12,000 gift tax annual exclusions by making gifts to a so-called “529 Plan.” A 529 Plan is a state-sponsored investment vehicle that permits a contribution of cash to an investment account. The funds eventually can be used to pay for higher education expenses, including tuition, fees, supplies, books, equipment, and limited room and board. These plans differ from the prepaid tuition plans operated by some states because the funds in a 529 Plan can be used at any institution, public or private, in any state, and even some foreign institutions.

The creator of a 529 Plan is called the “account owner” and the account also must have a beneficiary. Every state has its own 529 Plan, with requirements that vary. A 529 Plan can be created in any state. Neither the account owner nor the beneficiary needs to be a resident of the state chosen, and the eventual higher education institution need not be in that state either.

Upon opening an account, the account owner must designate a beneficiary of the plan. The beneficiary can be any person who will foreseeably attend college or graduate school in the future, including the account owner himself and even non-family members. If the beneficiary later decides not to attend college, the account owner can designate a new beneficiary of the account. The new beneficiary must be a member of the prior beneficiary’s family, but this is a broadly defined group of individuals. A separate 529 Plan can be created and funded for as many persons as a donor wishes.

529 Plans provide substantial tax benefits. The investment returns in a 529 Plan accumulate income tax free, and if distributions are made for qualified higher education expenses, no income taxes are due on the distributions. In some states, there is also no state income tax due on qualified distributions even if a beneficiary receives a distribution from a “foreign” 529 Plan. Illinois recently adopted this rule. If the funds are withdrawn for other expenses, the beneficiary will be subject to federal and state income taxes and a 10% federal penalty.

Some states add additional tax benefits. For instance, a New York resident is entitled to a New York State income tax deduction of up to \$5,000 (\$10,000 if married, filing jointly) for contributions to a New York 529 Plan, and an Illinois resident is entitled to a State of Illinois income tax deduction of up to \$10,000 (\$20,000 if married, filing jointly) for contributions to an Illinois 529 Plan. However, Illinois now, in effect, takes back the account owner’s Illinois tax benefit if the funds are later transferred to a non-Illinois plan.

Ordinarily, the assets in a 529 Plan are not included in either the estate of the account owner or the beneficiary, meaning they are not subject to federal estate tax. While contributions to a 529 Plan are considered taxable gifts, they qualify for the \$12,000 annual exclusion. Additionally, a contribution of up to \$60,000 in one calendar year can be sheltered from gift tax by using five years’ of annual exclusion (the year of the contribution plus the next four years). This means a married couple can make a contribution of up to \$120,000 at one time, but this does consume five years’ annual exclusions for gifts to the beneficiary for both spouses. If a donor dies before five years after such a contribution was made, some of the gift is likely to be taxed in his or her estate.

**Coverdell Education Savings Accounts.** As a supplement to other education resources, a grandparent or parent may wish to consider funding a Coverdell Education Savings Account (“ESA”) (formerly known as an Education IRA). While an ESA is similar to a 529 Plan in purpose and tax benefits, there are several important distinctions.

Unlike a 529 Plan, an ESA’s use is not limited to higher education expenses. In addition to the qualified expenses of 529 Plans, ESAs may be used to pay for academic tutoring and limited expenses for elementary and secondary education (such as uniforms and transportation), as well as special needs education expenses.

Contributions to an ESA for a given year may be made at any time before the due date (without extension) of the contributor’s personal income tax return. Contributions are not deductible for federal income tax purposes but investment returns accumulate tax free. With investment options similar to traditional IRAs, ESAs offer more investment options than 529 Plans. For gift tax purposes, contributions to an ESA are treated the same as contributions to a 529 Plan (including the special five-year provision).

In several key areas ESAs are more restrictive than 529 Plans. Contributors to an ESA are subject to income limitations — the ability to contribute to an ESA begins to phase out at an adjusted gross income of \$95,000 (\$110,000 for joint filers). Individuals having an adjusted gross income greater than \$110,000 (\$220,000 for joint filers) are precluded from contributing to an ESA. (However, contributions to an ESA may be made by organizations, such as trusts and corporations, without an income limit, so the individual income limitation may be legally avoided with proper planning.) In addition to the income limitation, contributions may be made to an ESA only if the beneficiary is under the age of 18, or has special needs. Although there is no limit on the number of ESAs that may be created for an individual, the sum of all contributions for one beneficiary from all sources may not exceed \$2,000 per year — any contributions in excess of this limitation are subject to a 6% excise tax unless the excess is distributed (along with a proportionate amount of income) by June 1 of the following year.

An ESA must be paid out within 30 days of the beneficiary’s 30th birthday (except in the case of a special needs beneficiary), at which time any income not used for qualified expenses will be subject to income tax plus a 10% penalty. This result may be avoided if the beneficiary rolls the ESA over to an ESA for a member of the beneficiary’s family, which is a broadly defined group of individuals (note that the annual \$2,000 per beneficiary limitation does not apply to funds that are rolled into an ESA).

**Direct Payments of Tuition.** As discussed above, it is also possible in some circumstances to make payments directly to a school without consuming either the annual exclusion amount or the donor’s lifetime gift tax exemption. The exception is for tuition payments made directly to a qualifying educational organization. Whether a payment falls within this exclusion depends on (1) whether it qualifies as “tuition,” and (2) whether the recipient organization qualifies as an “educational organization.”

“Tuition” means the amount of money required to enroll, full- or part-time, in an educational program. Fees for books and supplies and the cost of room and board are specifically *excluded* from the definition.

The definition of an “educational organization” encompasses more than just elementary, junior high, preparatory and high schools, and colleges and universities. An organization (1) the primary function of which is formal instruction, and (2) which has a regular faculty and curriculum, (3) a regularly enrolled student body, and (4) a place where its educational activities are regularly carried on, would also satisfy the definition. Exactly what activities and organizations fit these conditions is not always clear, and there is not a lot of guidance in this area. For example, a place where educational activities are regularly carried on does not require that activity occur every day or all year round; the “place” need not be a classroom or even a specific building (an educational program conducted outdoors on an island had a “place”). However, here are some examples of things that have been ruled to either qualify or not qualify:

**Yes:**

- Yoga, when conducted as an integrated eight-week course with a set curriculum
- Wilderness training as part of a camping program, where the focus is on survival skills and first aid (not on recreational camping)
- Martial arts school instructors (if they have training and skill in martial arts)
- A camping program for at-risk teenagers (if chosen based on their academic credentials in social science and mental health)
- Yoga instruction (class only once a week)
- Pre-school (only part time)
- A wilderness program that conducts twenty-six day trips, ten months out of the year

**No:**

- A program that, in addition to instruction about nature skills, includes recreational kayaking, camping and mountain biking
- A day camp that has both educational and recreational activities
- Boys club offering optional courses
- Organization offering a variety of workshops, lectures and short courses on a variety of unrelated subjects
- A tutoring organization that tutored students part-time for several hours a week
- A day care program that allows children to be dropped-off and picked-up according to the needs of the families

As one can see, there is no bright line test for what qualifies as an acceptable activity or organization, so a person contemplating making a payment under these circumstances should act with care.

It should be remembered that payment of qualified *medical* expenses directly to the provider of those services also qualifies for this unlimited gift tax exemption.

**Custodial Accounts and Trusts.** If a donor does not choose a 529 Plan or an ESA as the vehicle for a gift to a minor, the two major remaining options are a custodial account and a trust. There are benefits and detriments to both options.

**Custodial Accounts.** Every state has some version of the Uniform Transfers to Minors Act (“UTMA”), which allows a donor to designate a custodian for the minor who will accept the gift on the minor’s behalf. The custodian is then responsible for the investment and distribution of the assets for the minor’s benefit. The donor should not be the custodian. Otherwise the IRS may assert the assets should be included in the donor’s estate for federal estate tax purposes.

The main advantage of the custodial account is its relative simplicity. If cash or marketable securities are given, a custodial account can be opened at a bank or brokerage firm without the need for any additional documentation. The income from the account is taxable to the minor, subject to the “kiddie tax” rules which may cause the income taxes to be calculated based on the parents’ tax rate. Thus, while the child will need to file a tax return, no separate tax return is required for the account.

However, simplicity can have its price. Under UTMA, the custodial account must terminate no later than the 21st birthday of the donee. This means that if the funds have not been used prior to that date, the donee will become outright owner of those amounts. If the donor has made only modest transfers to the account, or if most of the funds are used for college, this may not be an issue. Many times, though, several hundred thousand dollars may remain in those accounts, and many parents are reluctant to have a 21-year-old suddenly receive such a large sum of money. Although in Illinois there is an option to move a custodial account to a Minor Exclusion Trust (described below), we do not recommend custodial accounts in most cases because of this potential problem.

**Trusts.** A trust is another vehicle for gifts to minors. In general, trusts offer more flexibility than the other techniques previously discussed and are more appropriate for larger gifts. There are two main types of trusts for gifts to minors — a Minor Exclusion Trust (also known as a 2503(c) trust) and a so-called “Crummey” trust.

**Minor Exclusion Trusts.** The statute authorizing the Minor Exclusion Trust requires that while the minor is under age 21, the trustee must use the income and principal for the benefit of the minor and the minor must be the only beneficiary. When the beneficiary reaches age 21, he or she must be given the right to withdraw all of the remaining property. This right can be limited in duration, so if the beneficiary does not exercise this right within, say, 30 days, the property can be retained in trust. If the beneficiary dies before termination of the trust, the remaining property will be included in his or her estate for federal estate tax purposes. Gifts to a Minor Exclusion Trust will automatically qualify for the donor’s \$12,000 gift tax annual exclusion (and a similar exclusion for generation-skipping tax purposes if the donor is a grandparent) while the beneficiary is under age 21. If gifts are to be made after that date, a Crummey power (discussed below) will have to be incorporated into the trust.

The trust will generally be considered a separate taxpayer for federal income tax purposes. Thus, the trust would file a tax return and pay tax based on the compressed brackets applicable to trusts. Alternatively, the creator of the trust could make the trust a “grantor trust” for federal income tax purposes and pay the income tax himself or herself, thereby eliminating the need for the tax return and, in effect, increasing the gift to the beneficiary.

**Crummey Trusts.** “Crummey” trusts are named for the taxpayer whose Tax Court case made it famous. Under a Crummey trust, the beneficiary is given the right to withdraw trust property each time a gift is made to the trust. Oftentimes, this right is limited to a period such as 30 days. If the beneficiary does not exercise this power, the power lapses and the property remains in the trust. While the beneficiary is a minor, his or her parent or guardian can exercise this power on his or her behalf. The trust does not have to terminate when the beneficiary reaches age 21. In fact, the property can remain in trust forever if the trust is drafted that way.

Unlike a Minor Exclusion Trust, a Crummey trust can have multiple beneficiaries (although if the donor is a grandparent it may be more tax efficient to have only one beneficiary per trust). A Crummey trust also can be created as a grantor trust for federal income tax purposes. Since the beneficiary does not need to be given a full withdrawal right at age 21, a Crummey trust is often more appropriate when larger gifts are involved. Crummey trusts also can benefit multiple generations without transfer tax, which is not the case with a Minor Exclusion Trust. For donors with assets of several million dollars or more, the Crummey trust combined with direct tuition and medical expense payments, often provides a superior tax result, compared to 529 or Coverdell Accounts.

**Impact on Financial Aid.** An often overlooked aspect of saving for education is the impact on a college-age student’s ability to obtain financial aid. A parent or grandparent who has set aside assets for a child’s college education may decide it would be preferable to avoid using the funds for college costs, and instead save them for the child’s graduate school education or to help the child when starting out after his or her education. Yet, the existence of those funds usually will count in some manner in determining the availability of financial aid.

The various forms of accounts and trusts for saving for education are treated for financial aid purposes as follows:

- Custodial account — treated as an asset of the student.
- Minor Exclusion Trust (or other trust solely for benefit of student) — treated as an asset of the student.
- Trust with parent(s) as sole current beneficiary — treated as an asset of parent(s).
- Crummey trust with student or parent(s) as a beneficiary — portion of trust may be treated as an asset of the student or parent(s), as the case may be.
- 529 Plan — listed as an asset of the owner (the parent or grandparent who created the account).
- Education IRA — listed as an asset of the student.

There is nothing in the standard financial aid form that appears to recognize the nature of a trust and the beneficiary's limited interest in a trust. For example, and most importantly, the form does not contemplate the existence of "spray" trusts, where the student and/or the parent(s) may be only one of multiple beneficiaries, none of whose rights are defined with certainty. There is no recognition that a future interest in a trust usually does not increase a beneficiary's current net worth. Most future interests are contingent on survival, so there is no guarantee that the beneficiary will receive the property. In addition, most trusts contain "spendthrift" clauses that preclude a beneficiary from borrowing against the trust interest or selling it. There is no recognition that a trust could specify that trust funds are for purposes other than education, or that the trust could specifically prohibit its use for education. In each of these circumstances, it may be helpful for the trustee or the attorney for the family to write a letter to the financial aid officer explaining why the trust assets should not be counted.

From a financial aid standpoint, a Section 529 Plan created by a grandparent or other relative (besides a parent) provides one of the best options. It does not show up as an asset of either the parent or the child.

**Generation-Skipping Tax.** Whenever a grandparent makes a gift to a grandchild, the generation-skipping tax implications of the gift must be remembered. Each individual has a \$2 million GST exemption that protects either lifetime or testamentary transfers from generation-skipping tax. In addition, certain gifts to grandchildren (or more remote descendants) will also qualify for a \$12,000 generation-skipping tax annual exclusion, which is similar to the gift tax annual exclusion. However, not all gifts to grandchildren that qualify for the gift tax annual exclusion will automatically qualify for the generation-skipping tax annual exclusion.

Gifts to 529 Plans and ESAs that do not exceed the \$12,000 gift tax annual exclusion and unlimited direct payments of tuition and medical expenses will qualify for the GST annual exclusion. Likewise, gifts to custodial accounts and to Minor Exclusion Trusts that do not exceed the gift tax annual exclusion also will qualify for GST annual exclusion treatment. However, gifts to Crummey trusts will not necessarily qualify for this treatment unless has only one beneficiary — the grandchild — and other technical rules are satisfied. Qualifying gifts for the GST annual exclusion will be beneficial since that conserves the donor's \$2 million lifetime GST exemption and will allow the donor ultimately to pass more property to his or her grandchildren without transfer tax.

## *Planning Tip*

### **Powers of Attorney and Health Care Proxies for Adult Children**

While few of our clients need to be reminded that powers of attorney and health care proxies are integral parts of a complete estate plan, most clients do not consider asking their children to execute these documents. Yet, in the absence of properly executed powers of attorney, depending on state law, once a child attains the age of majority, the child's parents may lose the ability to handle his or her medical and financial issues, even in exigent situations where the child is unable or unavailable to act. Further, under the Health Insurance Portability and Accountability Act ("HIPAA"), medical providers often are unable to provide medical information to anyone, including a patient's parents, without the consent of the patient. The preparation and execution of powers of attorney and health care proxies are relatively simple. The alternative is often a costly and ill-timed court proceeding to obtain authorization to handle a child's medical or financial issues at a moment when a parent may be preoccupied with a child's needs. If you or your child has any questions regarding health care proxies and powers of attorney, please contact a member of **Schiff Hardin's Private Clients, Trusts and Estates** group and we will be happy to assist you.



# Private Clients, Trusts and Estates

*Attorneys*

**Thomas W. Abendroth**  
312.258.5501  
tabendroth@schiffhardin.com

**Barry S. Alberts**  
312.258.5611  
balberts@schiffhardin.com  
Trust and Estate Litigation

**Scott Bieber**  
312.258.5636  
sbieber@schiffhardin.com

**David C. Blickenstaff**  
312.258.5637  
dblickenstaff@schiffhardin.com  
Trust and Estate Litigation

**Harmon A. Brown**  
312.258.5690  
hbrown@schiffhardin.com

**Reetu Chauhan**  
312.258.5732  
rchauhan@schiffhardin.com

**Lisa M. Chessare**  
312.258.5693  
lchessare@schiffhardin.com

**John D. Dadakis**  
212.745.0860  
jdadakis@schiffhardin.com

**Louise M. Fitzsimons**  
212.745.0822  
lfitzsimons@schiffhardin.com

**P. Gregory Hess**  
212.745.0812  
ghess@schiffhardin.com

**David R. Hodgman**  
312.258.5714  
dhodgman@schiffhardin.com

**Carter Howard**  
847.853.2525  
choward@interaccess.com

**Michael J. Huft**  
312.258.5627  
mhuft@schiffhardin.com

**Kim A. Kamin**  
312.258.5621  
kkamin@schiffhardin.com

**Robert E. Kolek**  
312.258.5755  
rkolek@schiffhardin.com

**Katherine J. Levy**  
847.295.4305  
klevy@schiffhardin.com

**Theresa M. H. Marx**  
312.258.5562  
thellmann@schiffhardin.com

**David A. Milberg**  
312.258.4579  
dmilberg@schiffhardin.com

**Margaret A. Nagela**  
312.258.5518  
mnagela@schiffhardin.com

**Scott L. Newman**  
212.745.9531  
snewman@schiffhardin.com

**Robert R. Pluth, Jr.**  
312.258.5535  
rpluth@schiffhardin.com

**Christine R.W. Quigley**  
312.258.5761  
cquigley@schiffhardin.com

**Debra L. Stetter**  
312.258.5741  
dstetter@schiffhardin.com

**Thomas R. Wechter**  
312.258.5756  
twechter@schiffhardin.com

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6600 Sears Tower  
Chicago, Illinois 60606

