



# Will Power

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## TAX ADVANTAGES FOR PREPAID TUITION EXPENSES

I am often asked the following questions: how can I most efficiently provide for the education of my grandchildren or great-grandchildren (or other family members)?” “What simple ways are there to remove significant wealth from my estate so it is not subject to federal estate taxes?”

A recent Private Letter Ruling (PLR 200602002) answers both of these questions with an intriguing idea. The IRS agreed in that ruling that the pre-payment of tuition made directly to a school on behalf of a grandchild enrolled in that school is an exempt payment that escapes both gift and generation skipping tax (GST).

### FACTS:

The donor, the school, and the grandchildren’s respective parents entered into six separate agreements, one for each grandchild. Each agreement provided that:

1. the funds would be used for that grandchild’s tuition,
2. any shortfalls caused by higher-than-projected tuition increases would be made up by the donor or by that grandchild’s parents,
3. any funds not used for tuition for that grandchild would not be refunded or transferred to the other grandchildren, but would become the sole property of the school. The agreement further provided that the tuition prepayments would not affect the grandchild’s eligibility for enrollment, which would continue to be subject to the school’s usual policies and procedures.

### CONSIDER THE POSSIBILITIES!

It is well known that direct gifts to any individual are exempt from gift tax up to a specified “annual gift tax exclusion” each year. In 2006, that annual exclusion limit is \$12,000 for each recipient (up from \$11,000 in 2005); with proper planning, a married couple can give gift tax free as much as \$24,000 per recipient! In addition, payments made on another’s behalf directly to a school for tuition (or directly to a provider of medical care) are exempt from gift tax WITHOUT ANY DOLLAR LIMIT! None of these types of gifts will be subject to the GST tax, even if made to or for a grandchild or younger descendant, and none of them will have any adverse effect on the calculation of the estate tax.

### PRE-PAYMENTS FAVORABLY TREATED!

PLR 200602002 held that under the facts described above the pre-payment of tuition made directly to a school on behalf of a grandchild enrolled in that school is an exempt payment that escapes gift and GST tax. The IRS confirmed this favorable tax treatment for tuition payments to a private school for each year up through graduation (grade 12) for each of the donor’s six grandchildren. Of course, PLRs may not be cited as precedent by any other taxpayer. But the result confirmed in the ruling is clearly consistent with the law and with other known expressions of IRS views.

### NUMBERS SPEAK FOR THEMSELVES!

Tuition prepayments as contemplated in this ruling can be a very valuable technique.

### EXAMPLE:

Assume the six grandchildren in the ruling were in grades K, 1, 2, 3, 4, and 5. Suppose the anticipated tuition through grade 12 averaged \$15,000 per year. The donor could transfer a total of almost \$1,000,000 in this manner without ANY gift, GST, or estate tax! None of what is in effect a \$1,000,000 cumulative gift tax exemption and \$2,000,000 GST or estate tax exemption would have to be applied to this payment. The donor would not even use any of his or her \$12,000 annual gift tax exclusion, which could then be used for yet additional gifts to the grandchildren that year!

### DOWNSIDES:

The chief drawback of this technique is that each amount paid must be for a designated student at that student’s current school. The amount paid cannot be transferred or “rolled over” to any other student or used at any other school. But even that drawback can be avoided if the donor can simply wait and make direct tuition payments free of gift tax each year as the tuition is due. It can also be avoided, subject to certain limits, by the use of a qualified tuition program (“529 plan”).

If a student (or students) is (are) already enrolled in a school, this drawback might be far outweighed by the certainty of being able to shield a substantial sum from gift, GST, and estate taxes, even if the donor dies or becomes incapacitated, while leaving the donor’s per donee \$12,000 annual gift tax exclusion completely intact.

### VISIT WITH YOUR LAWYER

Before embarking on any plan you should visit with your estate-planning attorney. I suggest that any tuition prepayment arrangement that seeks these tax benefits closely follow the pattern described above. While there is no clear reason why the same tax treatment could not be obtained with respect to other living grandchildren who are not yet enrolled in the school, the ruling does not go that far, and the tax result in that case would not be as sure.

Pre-payment of a grandchild’s tuition could be an ideal technique for a donor with young grandchildren or even great-grandchildren who is not assured of surviving to see the completion of their education.

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