

IRS backs novel way to avoid gift taxes

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By Tom Herman and Rachel Emma Silverman, The Wall Street Journal

Bolstered by a recent IRS ruling, a small but growing number of wealthy individuals are cutting their tax bills by prepaying family members' tuition bills for multiple years.

Tax advisers say this technique could be a smart move for people with large estates who want to pay for a student's tuition and fear they might not live long enough to pay as the bills come due each year. This way, they can help their families deal with soaring education costs and skirt hefty estate and gift taxes. But the technique is also proving popular with younger, healthy individuals.

Private schools and colleges are seeing more relatives adopting the strategy, and some are now actively encouraging families to prepay tuition bills, which at some elite private schools can run nearly \$30,000 per year.

"I've had about about half a dozen clients do it," says Susan C. Frunzi, a partner at the law firm Schulte Roth & Zabel LLP in New York. She says the longest prepayment period was about four or five years. It's not just being used by grandparents, either: Ms. Frunzi says some clients have done it for nieces and nephews -- or the children of friends who are less well off. Her firm has even prepared a sample prepayment agreement for one of the schools it represents.

The tactic deftly addresses two powerful developments: the soaring cost of education and the huge impending transfer of intergenerational wealth. At the same time, the parents of boomers are poised to transfer unprecedented amounts of wealth when they die and to many, finding tax-efficient ways to share that wealth while they are still alive is an important priority.

"It's becoming a very popular way of avoiding estate taxes," says Bruce Amsbary, business manger of the Rivers School in Weston, Mass., which has seen a rise in the practice over the past few years.

The strategy is also beginning to attract more attention among tax professionals. The American Institute of Certified Public Accountants recently said that for people primarily interested in transferring wealth, multiyear prepayments provide a method of paying for multiple years of educational costs "while keeping the taxpayer's annual exclusion amounts available for other gifts."

One of the main attractions of the direct-prepayment strategy is its simplicity. There's no need to hire a lawyer to draft complex trusts or other sophisticated wealth-transfer techniques. For those skittish about laying out cash for a number of years, there are some

tax-efficient alternatives, such as funding a 529 college-savings plan; setting up a Health and Education Exclusion Trust, which can pay for multiple generations of heirs; or simply directly paying annual tuition costs each year.

A recently released private-letter ruling by the Internal Revenue Service is fueling more interest in the subject among tax lawyers and other financial advisers. In the ruling, the IRS told a taxpayer that multiyear prepayments of tuition for the taxpayer's grandchildren wouldn't be considered a gift for tax purposes. The taxpayer in question proposed prepaying tuition bills for each of six grandchildren through 12th grade.

Under current law, you can hand out as much as \$12,000 a year per person to anyone you want without even having to report it to the IRS. Yet that annual limit doesn't count if you pay for someone else's tuition or medical expenses, no matter how large your payments may be -- as long as those payments are made directly to the educational institution or medical-service provider. Thus, you can move large amounts of money out of your estate, tax-free, without even having to report your gifts to the IRS -- and without eating into any of your estate tax or lifetime gift-tax exclusion amounts. (The lifetime gift-tax exclusion amount is \$1 million. The basic federal estate-tax exclusion amount is \$2 million this year, although one spouse typically can leave everything to the other spouse free of estate tax. However, there may be state tax factors to consider.)

Many people long have taken advantage of this provision by making direct payments to schools for a single year of tuition. The IRS's latest ruling gave additional assurance that prepayments for multiple years also would be acceptable.

The prepayments the IRS ruled on didn't entitle the grandparent to any tuition discounts. All tuition payments would be "nonrefundable" and, once paid, would become the school's "sole property" -- even if the students stopped going to that school. They wouldn't entitle the kids to "any additional rights or privileges over any other student" -- and also wouldn't guarantee enrollment.

There are some risks to the multiyear approach. The child may refuse to attend the school, may transfer out, may get expelled -- or drop out. A possible solution, according to one accountant, would be to arrange ahead of time with the first school to have the tuition money transferred directly to a second school in case the child eventually transfers. Thus, if you're considering prepaying, be sure to ask the school for details of its policy. But the IRS hasn't specifically addressed this issue, and some lawyers think that such an agreement may not pass IRS muster.

Some schools, including colleges such as Harvard and Middlebury and prep schools such as Phillips Academy in Andover, Mass., offer special prepaid plans designed to lock in tuition rates up front. Before you sign up, check with a tax expert and have him or her examine the fine print to make sure it wouldn't lead to unintended tax consequences.

A number of schools report receiving prepayments. For example, within the past two or three years, the Brentwood School in Los Angeles has received prepayments by about

four or five grandparents, says Mary Sidell of Brentwood, which has 992 students from kindergarten through grade 12. One prepaid for several children for 10-12 years in advance, she says.

In 2002, the Saint James School, in Montgomery, Ala., drafted an official prepayment agreement as an alternative, and tax-efficient, way for students' family members or friends to pay school costs. "Did you know? -- grandparents and others who would like to legally avoid the federal gift tax on large amounts of money can do so by prepaying tuition for their grandchildren or any child for that matter," said a school newsletter sent to students' families.

Only one person, so far, has taken advantage of the school's prepayment agreement. A grandfather, he was in poor health when he decided to fund two of his grandchildren's education for a couple of years. "The money didn't end up in his estate at all," says William Furr, Saint James' controller and business manager. "It was a really good move on his part."

Even with the risks, this could still be a smart move for some people -- but is best suited for those who are concerned they might not live long enough to pay each year's tuition as it comes up, could afford to part with the money permanently, are comfortable the child will complete education at that school and are willing for the school to keep the money in any event.

This ruling confirms the gist of an IRS technical advice memorandum issued in 1999 based on slightly different facts. That memo and the new IRS private-letter ruling apply only to the specific taxpayers involved and aren't supposed to be cited as precedent. But tax advisers say the new ruling is helpful anyway because it offers the IRS's latest thinking on the subject -- and provides additional comfort to anyone who might fear the IRS now might have a different opinion than in 1999.

How It Works

A growing number of wealthy individuals are choosing to directly prepay tuition for family members in multiyear chunks:

- This technique can move large amounts of money out of their estate, saving on future taxes.
- Such payments don't have to be reported to the IRS, and are not subject to gift taxes.
- A recently released IRS private-letter ruling offers more assurance to those considering this strategy. But there may be risks, such as if the student leaves the school.