



The Doctor Is In; School Is In Session: Answers on the Use of the Gift Tax Medical and Tuition Expense Exclusion

Written by:

Thomas W. Abendroth

tabendroth@schiffhardin.com

312.258.5501

Originally published in *ABA Trust & Investments*

May/June 2008

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

225 Franklin Street, Suite 2600
Boston, MA 02110
t 617.848.5750 f 617.848.5784

6600 Sears Tower
233 South Wacker Drive
Chicago, IL 60606-6473
t 312.258.5500 f 312.258.5600

One Westminster Place
Lake Forest, IL 60045-1885
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
Thirty-Second Floor
San Francisco, CA 94105
t 415.901.8700 f 415.901.8701

1666 K Street NW, Suite 300
Washington, DC 20006
t 202.778.6400 f 202.778.6460

www.schiffhardin.com

What is the gift tax exclusion for payment of medical and tuition expenses?

Under Section 2503(e) of the Internal Revenue Code (the "Code"), tuition payments made directly to an educational organization on behalf of a person, and payments for a person's medical care made directly to the provider are not treated as taxable gifts. This can be an important exclusion for planning purposes. For example, grandparents who already take full advantage of the annual exclusion for gifts to grandchildren can make additional tax-free transfers by paying their grandchildren's tuition for private school or college.

What education expenses besides tuition fall under the exclusion?

The education expense exclusion is limited to tuition. Tuition means the amount of money required for enrollment. It includes tuition for part-time students. It does not cover books, supplies, room and board or similar expenses. See Treas. Reg. §25.2503-6(b)(2)(3). One issue, on which there appears to be no guidance, concerns institutions such as boarding schools which do not break out their fees between teaching expenses and room and board and instead charge one tuition fee. The commonly accepted practice is to claim the full fee charged by such an institution as qualifying for the Section 2503(e) exclusion. The IRS, at some point in the future, could challenge this.

Are there limits on the types of schools or educational organizations that qualify?

To qualify for the exclusion, the payment of tuition must be to an educational organization of the type described in Section 170(b)(1)(A)(ii). See IRC § 2503(e)(2)(A). Section 170(b)(1)(A)(ii) defines an educational organization as one that normally maintains a regular faculty and curriculum and has a regularly enrolled body of students in attendance at the place where the educational activities are being carried on. Treas. Reg. § 1.170A-9(b)(1). The presentation of formal instruction must be the primary function of the organization.

Do private primary and secondary schools qualify? What about pre-schools?

The regulations under Section 170 specify that primary, secondary, preparatory schools, high schools and colleges and universities all are considered "educational organizations". The gray area, addressed in IRS rulings, concerns nursery or pre-schools, and schools in other instructional areas. The inquiry is a fact-specific one. There is guidance in the form of public and private rulings. The public rulings address qualification as an educational organization for purposes of qualifying for exemptions from other federal taxes, such as fuels or communications taxes, and not the application of Section 2503(e). Nevertheless, they are instructive since the definition of educational organization is the same.

In Revenue Ruling 78-446, 1978-2 C.B. 257, the IRS ruled that a children's day care center satisfied the definition of educational organization for purposes of exemption from certain taxes because it had a regular enrollment, planned educational activities, and instruction from a staff of teachers and assistants. Another day care program was found not to have educational activities as its primary purpose, where its function was more custodial in nature. Revenue Ruling 78-446.

Other providers of educational activities that have been found to qualify as educational organizations include a martial arts school, an instruction academy for yoga and a wilderness camping and survival program. The IRS concluded that the martial arts school's primary function was the presentation of formal instruction, its courses were interrelated and given in a regular and continuous manner, thereby constituting a curriculum, it maintained a regular faculty, and had a regularly enrolled body of students. Rev. Rul. 78-309, 1978-2 C.B. 123.

For the organization providing yoga instruction and promoting the practice of yoga, the IRS was careful to distinguish its program of eight week yoga courses, which did qualify, and its other activities, which did not. Rev. Rul. 79-130, 1979-1 C. B. 332. Payment

for the eight-week course presumably would qualify as a direct payment of tuition. Payment for individual classes or other activities would not. In Revenue Ruling 83-140, 1983-2 C. B. 185, the IRS approved a wilderness company program for adolescents with emotional and behavioral problems. While this program lacked a traditional classroom setting, it had qualified instructors and an organized plan of instruction, which was taught during 26-day hiking and camping trips, repeated 10 months of the year. Based on this ruling, payments for certain types of summer camps, such as music, art or computer camps, also might qualify.

Does the exclusion apply to tuition payments to a religious school or to a school in a foreign country?

Yes, if the school otherwise qualifies as an educational organization.

Do you lose the exclusion if the school is watch-listed under the no child left behind legislation?

No. And do not even whisper the thought anywhere near Washington D.C.

What medical expenses qualify for the exclusion?

Qualifying medical expenses are defined by reference to Code Section 213(d). See IRC § 2503(e)(2)(B). The exclusion applies to payments for (i) the diagnosis, cure, mitigation, treatment or prevention of disease, (ii) the purpose of affecting any structure or function of the body, or (iii) transportation primary for and essential to medical care. Treas. Reg. § 25.2503-6(b)(3). Payments for medical insurance are covered. The Section 213(d) definition of medical care is extremely broad. It also covers long-term care services, such as the costs of nursing homes or assisted living facilities, if provided by a licensed health care provider. The most notable area it does not cover is cosmetic surgery, unless to correct a birth defect or disfigurement from injury or disease. See IRC § 213(d)(9)(A).

What if the expenses subsequently are paid by health insurance?

If a donee's medical expenses are subsequently reimbursed by insurance, the donor's payment does not qualify for the exclusion. Treas. Reg. § 25.2503-6(b)(3). The donee must reimburse the donor. If he or she does not, the donor's payment will be treated as a taxable gift. The annual exclusion would apply to it if otherwise available.

Can I pay tuition or a doctor's bill for a child or other relative by giving that person the money?

In the case of both educational and medical expenses, the payment must be made directly to the provider. This is a key element of the exclusion. If an individual gives her grandchild \$5,000 to pay medical expenses, the gift does not qualify under Section 2503(e), even if the grandchild in fact uses the \$5,000 for that purpose.

Can I give a check to my child and let him or her use it to pay the expense?

Yes you can, if the check is made payable to the educational organization or medical service provider. You cannot make the check payable to the child and let him or her endorse it over.

How can I reduce the hassle of making payments directly?

For a taxpayer who wishes to take full advantage of this exclusion, the direct payment requirement does create administrative challenges. One solution is for the taxpayer to create an account, in the taxpayer's own name, for each child, and give the child check-writing authority as agent. It also may be possible to provide a credit card to the child tied to the account. The child then can directly pay medical or educational expenses for the child and his or her descendants from the account. Since the account is in the donor's name, and the child is acting only as agent, the direct payment requirement is satisfied.

Can I prepay several years of tuition?

It is possible to prepay tuition expenses under the Section 2503(e) exclusion. The IRS approved this in Technical Advice Memorandum 199941013 (July 9, 1999). For several years, the taxpayer in this ruling

had paid private school tuition for two grandchildren, both for the current year and for several future years. Over a three year period, she paid a total of \$181,410 to the school, covering the grandchildren's tuition for the following five years. The IRS ruled that the payments qualified for the exclusion under §2503(e) as long as they were not subject to refund. In the situation that was the subject of the ruling, the payments to the school would be forfeited if the grandchildren ceased to attend the school.

Letter Ruling 200602002 (January 13, 2006), provides another, more recent, example of prepayment. The donor proposed to prepay tuition for six of his grandchildren. Under the agreement the donor entered into with the school, he acknowledged that there may be future tuition increases, which he or the children's parents would pay, and that the pre-paid tuition was not refundable and did not guarantee enrollment for the grandchildren. The IRS ruled that the prepayment qualified as a Section 2503(e) transfer.

It would be permissible to negotiate with a school or college to apply unused tuition to another child or grandchild, or toward tuition at another school, should the child or grandchild to whom the tuition was applied drop out or transfer. However, the tuition cannot be refunded.

Are gifts using the exclusion subject to generation-skipping tax?

Transfers directly to the provider to pay tuition or medical expenses of a person, exempt from gift tax under Section 2503(e), are also exempt from GST tax. IRC § 2642(c)(3)(B). The exclusion from GST tax applies to payments from trusts as well as payments made by an individual. Therefore, if there is a trust not exempt from GST tax that has skip persons as beneficiaries, the trustee can make tuition or medical payments on behalf of the skip persons without incurring GST tax.

The availability of this exclusion has led to development of the Health and Education Exclusion Trust or "HEET". The HEET is an irrevocable trust

funded for the purpose of providing for the direct payment of tuition and medical expenses for grandchildren and more remote descendants. It is designed so that the grantor does not have to allocate GST exemption to the trust. Although the transfers out of the trust for medical or educational purposes can escape GST tax, the gift into the trust may not, even if the trust can only be used for those purposes. If the trust has one or more children as beneficiaries, there will be a taxable termination upon the death of the last of them to die. If the only beneficiaries of the trust from the beginning are grandchildren and more remote descendants, the transfer into the trust will be a direct skip and be subject to GST tax immediately.

The HEET trust attempts to avoid the GST tax by including a named charity as a beneficiary. Under Code Section 2651(f)(3), a charity will be a nonskip person, so the transfer into the trust will not be a direct skip. Since the charity will never die (or, if it does, the trust names a successor to it), there will be no taxable termination, either. It is safer to specifically name a charity rather than paying an amount to one or more charities to be selected by the trustee, to avoid an argument that there is no current interest in a nonskip person. At the end of the perpetuities period, or an earlier trust termination date, any remaining trust property is distributed to charity. Obviously, the grantor must have significant charitable desires to make this trust worthwhile. If that is the case, this trust can efficiently combine the grantor's twin goals of helping his or her family and charity.

There are two major drafting issues with a HEET. First, Code Section 2652(c)(2) disregards any interest that is used "primarily to postpone or avoid" the GST tax. If the charity does not have a significant enough interest, that interest will be ignored and a GST tax will be imposed when the trust is created. There is no IRS guidance on what constitutes enough of an interest to pass this test. Some commentators have suggested 25% of the income, while others have talked in terms of a unitrust type interest of around 5% of the trust value.

Second, there is the possibility that the IRS would seek to treat the trust as having two separate shares, with the share that does not contain the charitable interest immediately being treated as a direct skip. The regulations do not favor separate shares, so the IRS might have a hard time prevailing in this argument. One way that may help avoid the issue is to provide that the charity receives the lesser of a certain dollar amount and a percentage of the net income. If the dollar amount is higher than the amount that would be distributed as a percentage of the income, at least in the early years of the trust, it would be hard to claim that the charitable portion is a separate share. Moreover, the separate share rules require separate shares from the creation of the trust. See Treas. Reg. §26.2654-1(a)(1).

All these tax-free transfers are really available in addition to the annual exclusion?

Yes. For wealthy individuals, the Section 2503(e) exclusion is an often under-utilized opportunity for making tax-free transfers.

About the Author

Thomas W. Abendroth concentrates his practice in the fields of estate planning, federal transfer taxation, and estate and trust administration. His practice encompasses all phases of wealth preservation and transmittal, ranging from the preparation of wills and trusts to the implementation of multi-faceted transactions that reorganize business holdings in order to minimize transfer taxes.

Mr. Abendroth also advises banks and trust companies on fiduciary law and charitable issues. He has extensive trust and estate litigation experience, representing both beneficiaries and fiduciaries.

Mr. Abendroth has authored and co-authored numerous articles for industry publications, including *Trusts & Estates* and *ABA Trust & Investments*.

About Schiff Hardin LLP

Schiff Hardin LLP is a general practice law firm representing clients across the United States and around the world. We have nearly 400 attorneys in offices located in Atlanta, Boston, Chicago, Lake Forest, New York, San Francisco and Washington.

This publication has been prepared for the general information of clients and friends of the firm. It is not intended to provide legal advice with respect to any specific matter. Under rules applicable to the professional conduct of attorneys in various jurisdictions, it may be considered advertising material.

For more information visit our Web site at www.schiffhardin.com.

© 2008 Schiff Hardin LLP