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BUILDING AND SAFEGUARDING
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How Grandparents Can Help Grandchildren with College Costs



As the cost of a college education continues to climb, many grandparents are stepping in to help. This trend is expected to accelerate as baby boomers, many of whom went to college, become grandparents and start gifting what's predicted to be trillions of dollars over the coming decades.

Helping to pay for a grandchild's college education can bring great personal satisfaction and is a smart way for grandparents to pass on wealth without having to pay gift and estate taxes. So what are some ways to accomplish this goal?

Outright cash gifts

A common way for grandparents to help grandchildren with college costs is to make an outright gift of cash or securities. But this method has a couple of drawbacks. A gift of more than the annual federal gift tax exclusion amount — \$15,000 for individual gifts and \$30,000 for gifts made by a married couple in 2021 — might have gift tax and generation-skipping transfer (GST) tax consequences (GST tax is an additional gift tax imposed on gifts made to someone who is more than one generation below you). Another drawback is that a cash gift to a student will be considered untaxed income by the federal government's aid application, the FAFSA, and student income is assessed at a rate of 50%, which can impact financial aid eligibility.

One workaround is for the grandparent to give the cash gift to the parent instead of the grandchild, because gifts to parents do not need to be reported as income on the FAFSA. Another solution is to wait until your grandchild graduates college and then give a cash gift that can be used to pay off school loans. Yet another option is to pay the college directly.

Pay tuition directly to the college

Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. So grandparents don't have to worry about the \$15,000 annual federal gift tax exclusion. But payments can only be made for tuition

— room and board, books, fees, equipment, and other similar expenses don't qualify. Aside from the obvious tax advantage, paying tuition directly to the college ensures that your money will be used for the education purpose you intended, plus it removes the money from your estate. And you are still free to give your grandchild a separate tax-free gift each year up to the \$15,000 limit (\$30,000 for joint gifts).

However, colleges will often reduce a student's institutional financial aid by the amount of the grandparent's payment. So before sending a check, ask the college how it will affect your grandchild's eligibility for college-based aid. If your contribution will adversely affect your grandchild's aid package, particularly the scholarship or grant portion, consider gifting the money to your grandchild after graduation to help him or her pay off student loans.

529 plans

A 529 plan can be an excellent way for grandparents to contribute to a grandchild's college or graduate school education, while simultaneously paring down their own estate. Contributions to a 529 plan grow tax deferred, and withdrawals used for the beneficiary's qualified education expenses are completely tax free at the federal level (and generally at the state level, too). Participation in a 529 plan isn't restricted by income level and lifetime plan contribution limits are high, typically \$350,000 and up (limits vary by state).

There are actually two types of 529 plans: savings plans and prepaid tuition plans. A 529 savings plan is an individual investment account where you direct your contributions to one or more of the plan's investment portfolios, similar to a 401(k) plan. Funds in the account can be used to pay total qualified expenses (i.e., tuition, fees, room and board, books, supplies) at any accredited college in the United States or abroad. Funds can also be used to pay K-12 tuition expenses, up to \$10,000 per year. By contrast, the less common 529 prepaid tuition plan allows you to purchase college tuition credits at today's prices for use in the future at a limited group

Paying the college

Tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. But this is true only for tuition, not room and board, books, or fees.



of colleges that participate in the plan, typically in-state public colleges.

Grandparents can open a 529 account and name a grandchild as beneficiary (only one person can be listed as account owner, though) or they can contribute to an already existing 529 account. Grandparents can contribute a lump sum to a grandchild's 529 account, or they can contribute smaller, regular amounts.

Regarding lump-sum gifts, a big advantage of 529 plans is that under special rules unique to 529 plans, individuals can make a single lump-sum gift to a 529 plan of up to \$75,000 and married couples can make a joint gift of up to \$150,000 (which is five times the annual gift tax exclusion) and avoid federal gift tax. To do so, a special election must be made to treat the gift as if it were made in equal installments over a five-year period, and no additional gifts can be made to the beneficiary during this time.

Example: Mr. and Mrs. Brady make a lump-sum contribution of \$150,000 to their grandchild's 529 plan in Year 1, electing to treat the gift as if it were made over 5 years. The result is they are considered to have made annual gifts of \$30,000 (\$15,000 each) in Years 1 through 5 (\$150,000 / 5 years). Because the amount gifted by each grandparent is within the annual gift tax exclusion, the Bradys won't owe any gift tax (assuming they don't make any other gifts to this grandchild during the 5-year period). In Year 6, they can make another lump-sum contribution and repeat the process. In Year 11, they can do so again.

Significantly, this money is considered removed from the grandparents' estate, even though in the case of a grandparent-owned 529 account the grandparent would still retain control over the funds. There is a caveat, however. If a grandparent were to die during the five-year period, then a prorated portion of the contribution would be "recaptured" into the estate for estate tax purposes.

Example: In the previous example, if Mr. Brady were to die in Year 2, his total Year 1 and 2 contributions (\$30,000) would be excluded from his estate. But the remaining portion attributed to him in Years 3, 4, and 5 (\$45,000) would be included in his estate. The contributions attributed to Mrs. Brady (\$15,000 per year) would not be recaptured into the estate.

If grandparents want to open a 529 account for their grandchild, there are a few things to keep in mind.

If you need to withdraw the money in the 529 account for something other than your grandchild's college expenses — for example, for medical expenses or emergency purposes — there is a double consequence: the earnings portion of the withdrawal is subject to a 10% penalty and will be taxed at your ordinary income tax rate. Also, funds in a grandparent-owned 529 account may still be factored in when determining Medicaid eligibility, unless these funds are specifically exempted by state law.

Regarding financial aid, grandparent-owned 529 accounts do not need to be listed as an asset on the federal government's financial aid application, the FAFSA. However, distributions (withdrawals) from a grandparent-owned 529 plan are reported as untaxed income to the beneficiary (grandchild), and this income is assessed at 50% by the FAFSA. By contrast, parent-owned 529 accounts are reported as a parent asset on the FAFSA (and assessed at 5.6%) and distributions from parent-owned plans aren't counted as student income. To avoid having the distribution from a grandparent-owned 529 account count as student income, a grandparent can delay taking a distribution from the 529 plan until any time after January 1 of the grandchild's sophomore year of college (because subsequent FAFSAs will rely on income tax returns from previous years). Another option is to wait until after the grandchild graduates and use 529 funds to help pay down his or her student loans (there is a \$10,000 lifetime limit per 529 plan beneficiary on repaying student loans).

Colleges treat 529 plans differently for purposes of distributing their own financial aid. Generally, parent-owned and grandparent-owned 529 accounts are treated equally because colleges simply require a student to list all 529 plans for which he or she is the named beneficiary.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing; specific plan information is available in each issuer's official statement. There is the risk that investments may not perform well enough to cover college costs as anticipated. Also, before investing, consider whether your state offers any favorable state tax benefits for 529 plan participation, and whether these benefits are contingent on joining the in-state 529 plan. Other state benefits may include financial aid, scholarship funds, and protection from creditors.

Did you know ...

- If your grandchild doesn't go to college or gets a scholarship, you can name another grandchild as 529 account beneficiary with no penalty
- Many states offer income tax deductions for contributions to their 529 plan
- Money in a 529 savings plan can be used for K-12 tuition expenses too, up to \$10,000 per year

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