FUNDING THE GRANDKIDS' EDUCATION

BY BARBARA POTTER

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Paying for the grandkids' education can be extremely fulfilling – in and of itself. But it's also a major gift that can play an important role in effective estate planning. Let's run through the major options and pitfalls posed by the various funding options.

PAYING FOR TUITION DIRECTLY. The easiest thing to do is to pay tuition directly, on behalf of your grandchild. As long as you make payments straight to a Middlebury or a University of Washington — and you pay only for tuition — all your payments are not counted in terms of gift or estate taxes.

Of course, you can also pay for room-and-board and any other expenses. Up to $14,000 annually per grandchild is exempt from gift taxes ($28,000 if both you and your spouse are giving). Above that, however, you'll start to eat into your lifetime exemption from estate taxes ($5.34 million in 2014), as I explain below.

ANOTHER THING TO KEEP IN MIND: Has your grandchild applied for financial aid? Direct tuition payments usually reduce financial aid dollar-for-dollar. This is true for college-savings plans, too, although probably to a lesser extent.

FUNDING WITH ANNUAL GIFTS

If you have time to plan ahead – when the grandkids are in diapers or in grade school — you have lots more options.

But before we get into the options, it's important for you to understand how gift taxes work, because you're essentially giving your grandkids major gifts when you pay for their education.

Gifts are a way to pass wealth from one generation to the next. And the government allows for a certain amount of wealth transfer to happen without any extra tax consequences.

1. YOU CAN GIVE UP TO $14,000 ANNUALLY TO ANYONE – including of course your grandchild – without being subject to gift taxes. Your spouse can give another $14,000. So $28,000 annually per recipient. This annual exclusion is indexed to inflation, so it will rise over time.
2. UPON YOUR DEATH, UP TO $5.34 MILLION CAN PASS ON TO YOUR HEIRS, without having to pay the federal estate tax. Over that amount, the federal estate tax is 40%.

WHAT HAPPENS IF YOU GO OVER THE ANNUAL GIFT-TAX EXCLUSION LIMIT? Nothing right away. You don't actually pay gift taxes if you give more than the annual exemption. But you do have to file IRS Form 709 gift-tax return, which details the amounts over the annual gift exemption.

That overage is deducted from your estate-tax exemption, which as I mentioned earlier, is how much can be transferred to your heirs upon your death ($5.34 million), without incurring federal estate taxes. Say you make a $100,000 gift to a grandchild this year. This is $86,000 more than the annual exemption. So you've reduced your estate-tax exemption by $86,000 (down to $5.25 million).

TAX-ADVANTAGED OPTIONS

The major option in terms of tax-advantaged plans is Section 529 Plans (see box for the two types).

Each year, if you put up to $14,000 ($28,000 from you and your spouse) into one of these plans for a grandchild, you'll get those assets out of your taxable estate while also helping to pay for schooling in a tax-advantaged way.

Section 529 Plans are sponsored by states, state agencies or universities. Your grandchild would be the beneficiary of such accounts. But the account owner (you or the parents), can change the beneficiary any time.

The money in 529 Plans grows tax-free and can be withdrawn tax-free, as long as it's used to pay for education at a qualifying institution (most U.S. colleges and universities and some foreign schools). Otherwise, withdrawals are taxed on any appreciation plus a 10% penalty on the total withdrawn.

THERE'S A BIG ADVANTAGE TO 529 COLLEGE-SAVINGS PLANS: You can front-load five years' worth of giving and still keep within the gift-tax exemption:

$14,000 x 2 (you and your spouse) x 5 years = $140,000.

WHAT THIS MEANS: With a 529 Savings Plan, you can front-load $140,000 into a tax-advantaged 529 savings account for any one grandchild, while retaining the option to change beneficiaries.

TWO TYPES OF 529 PLANS

- 529 PRE-PAID TUITION PLANS
  Allow participants to lock in the price of tuition and fees at current rates (usually not room and board). Pre-paid plans usually limit you to certain schools and there's often a conversion formula if you go outside the network. In Washington State, this is the "Guaranteed Education Tuition" (GET) Plan.
- 529 COLLEGE-SAVINGS PLANS
  Are not guaranteed to cover tuition; they're subject to investment risk. However, withdrawals can be used to pay for various education expenses in addition to tuition, and contribution limits often exceed $300,000.

NOTE: Washington State does not offer its own 529 Savings Plan. But this is not a problem. Other states do, and you can invest in one of these through many of the major mutual fund companies, such as Vanguard and Fidelity.

For more info on 529 plans, one good resource is www.savingforcollege.com, where you can also see which colleges and universities qualify.

CUSTODIAL ACCOUNTS: BEWARE THE INS & OUTS

You could also consider custodial accounts, known as UTMAs and UGTAs (under the Uniform Transfers to Minors Act or the Uniform Gift to Minors Act). But pay careful attention to what these entail:

1. These are custodial accounts in the child's name, and this cannot be changed;
2. The account is subject to the "Kiddie Tax" on investment income over $2,000 annually (taxed at the guardian's highest marginal rate). The first $1,000 in investment income is tax-free; $1,000 to $2,000 is taxed at the lowest income-tax bracket;
3. The money can be used for anything, not just college; and
4. The child, at a relatively young age, will get full access to the assets. In Washington State, that age is 21.

WHEN A TRUST MAKES SENSE

If you have a lot of grandchildren and a large estate, and you want to control who will get money when for education, a trust can be the way to go. One example is what we call "pot" trusts, meaning money is put into a pot for a bunch of beneficiaries.

In such a trust, for example, you can get really specific, such as: only grandchildren with at least a 3.2 high-school GPA qualify for college funding, and as long as they maintain a 3.2 in college. Also, to ensure there will be enough money for the youngest grandkids, you could also specify no trust payout unless the beneficiary has exhausted all other options, including working part-time.

Of course, there are many types of trusts. And that's why we work closely with clients to make sure they have the right trust structure for their long-term needs.■

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