

HOW GRANDPARENTS CAN HELP PAY FOR GRANDCHILDREN'S COLLEGE EDUCATION

One of the best gifts grandparents can give their grandchildren is to help pay for their college education. A 2003 survey by AIG SunAmerica Mutual Funds found that 54 percent of grandparents were already helping pay college costs or planned to do so. Yet many grandparents don't realize the most effective ways of going about it, say financial planners.

Outright gifts. The AIG survey found that the vast majority gave outright gifts of cash or securities. This is certainly the easiest option. Each grandparent can annually give away, free of estate- or gift-tax liability, up to \$11,000 a grandchild—\$22,000 a year per grandchild if both grandparents contribute.

But this method has its drawbacks. Even \$22,000 a year may not be enough money for the grandchild's education (private colleges can easily run well over \$30,000 a year, and some are around \$40,000). Second, the gift could reduce the amount of available financial aid, particularly if the gift is made directly to the grandchild instead of the parents. And you're relinquishing control of the money—the grandchild could end up using the money for a new car or exotic vacation.

Pay tuition directly. A major advantage here is that by paying the money directly to the college the grandchild is attending, you can contribute as much as necessary without the gift counting as part of the annual \$11,000 gift exemption. You also ensure that the money is spent for college. The major drawbacks are that the gift only applies to tuition and it may reduce financial aid.

Coverdell education savings accounts. Grandparents who have earned income can directly open one of these accounts for a grandchild under the age of 18 and contribute up to \$2,000 a year. If they don't have earned income, they could gift the money to the parents to open the account. The grandparents can direct the investments as they choose, and the funds can be used for public and private elementary as well as secondary education.

There are some major drawbacks: the limited size of the annual contribution, donors whose income is too high cannot contribute and states don't provide any income-tax deductions. Also, the contributions and earnings belong to the beneficiary, not the donor, and financial aid may be affected. Of course, like any investment, there is the risk of losing money in the account.

529 plans. The AIG survey found that only two percent of grandparents had actually invested in a 529 plan on behalf of their grandchildren, though 529 plans can provide numerous benefits for both donors and recipients.

529 plans are state-sponsored college savings plans that invest money on behalf of participants much like mutual funds invest shareholder money. Under current law, earnings grow tax deferred from federal income tax and often state income tax, and withdrawals used for qualified education expenses will remain free of tax at least through 2010. The benefits for grandparents are numerous. They, not the grandchild, remain in control of the funds, yet the funds don't count toward their estate for estate tax purposes.

Donors also can consolidate five year's worth of tax-free gifting into a single year (\$55,000 per person or \$110,000 as a couple) as long as they don't contribute any more money within that five-year period. That means investing a lot of money upfront to grow for the grandchild. Most 529 plans allow total investments of at least \$200,000 and some allow over \$250,000. And unlike Coverdells, they are free of donor income limitations.

The plans are vulnerable to performance swings, just like mutual funds, and critics warn about potential high investment fees. Nonetheless, these remain a popular option for many parents, and can be very beneficial for grandparents.

Prepaid tuition plans. These plans, operated by some states and now by a consortium of private colleges, allow investors to buy part or all of tomorrow's tuition at today's prices. Typically, an investor buys "units," which might equal a semester, a year, or several years worth of today's tuition, and the state or private consortium guarantees returns that will match the inflation rate for that system's college costs.

The poor market returns in recent years and the high rate of tuition increases have prompted some states to drop these plans or freeze enrollment.

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