

The End of the “Grandparent Rule” – Plus Other Education Funding Strategies for Grandparents

A little-discussed change in education funding legislation now makes it easier for grandparents to give.

When Congress passed the Consolidated Appropriations Act of 2021 in December 2020, it made some significant tweaks to education planning – some good (a simplified FAFSA form!), some not so good (the removal of an aid benefit when multiple children attend college simultaneously). One major change for the better is the elimination of what’s known as the “grandparent rule”, planned to go into effect with the 2024-2025 FAFSA.

HOW ELIMINATING THE GRANDPARENT RULE WOULD HELP

Under the old rules, money distributed from a non-parent’s 529 account was treated as student income, which negatively impacts both the likelihood and amount of future student aid. As an example, let’s say in 2019 a grandparent withdrew \$20,000 to pay for tuition for

her grandchild’s freshman year. When the student applied for aid for the 2021–2022 academic year, 50% of that distribution, or \$10,000, would be reported as student income, significantly reducing the student’s potential aid package.

The new law eliminates the reporting of certain types of non-taxable aid given to the student – including distributions from a grandparent-owned 529 account. As a result, once in effect, were a grandparent to gift \$20,000 to her grandchild to help them pay for college, it would no longer be reported on the FAFSA, and the student wouldn’t be penalized by having additional income. (Note that the FAFSA does a prior-prior year look back on income and aid, which means this rule change could be beneficial to students as early as the 2022 calendar year, assuming the change is not delayed.) ►

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OTHER FINANCIAL AID STRATEGIES FOR GRANDPARENTS

529 distributions following the end of the grandparent rule aren't the only funding strategy grandparents should consider:

Superfunding. The IRS allows anyone to gift up to \$75,000 (or \$150,000 if filing jointly) to a 529 gift tax-free. The only stipulation is that you must elect the five-year gift rule on your IRS 709 form. Note that the gift is removed from your taxable estate only if you are living all five years – if you die in year 3, then two years of gifts will be added back to your estate.

Paying the school directly. If a grandparent were to give \$20,000 to a grandchild for schooling, the IRS would consider that a gift in excess of its \$15,000 annual gift limit. However, it makes an exception for tuition payments: Under the Gift Tax Education Exclusion for Tuition, any money gifted to a family member to pay for college tuition is not subject to the federal gift tax, so long as the tuition payment is made directly to the student's school.

Contributing to your grandchild's 529 (maybe). Unless your grandchild is a dependent, you won't qualify for a Lifetime Learning Credit or a refundable American Opportunity Tax Credit, nor will you earn tax deductions for tuition and fees. However, depending on where you live, you might earn a tax deduction or credit by contributing directly to a grandchild's 529 plan. Each state has its own rules, so be sure to check before deciding.

Incentivizing. For some families, it's important to have their student be financially invested in their education as a way to keep them motivated. You could decide to start your own match program, where for every dollar your grandchild contributes, you contribute \$2.

Waiting until after graduation. If your grandchild is planning on taking out student loans to pay for their education, you might consider choosing to help them pay off their debt post-graduation. This way there is no impact on your grandchild's eligibility for financial aid, and they can deduct loan interest of up to \$2,500 on their tax return. Refer to IRS Publication 970 for more information on tax benefits for education.

Staying up to date on the latest changes to education funding can be challenging. For the latest information on funding strategies, student debt and more, bookmark our Education Insights page on bairdwealth.com.

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Please reach out if you or anyone you know would benefit from discussing this topic further.