Possible College Gifting Moves for your Grandchildren

By Shelly Gigante

Grandparents with the financial resources to help pay for their grandchildren's college education can potentially lower their own tax liability while spreading the wealth.

Indeed, while no specific tax breaks exist for generous grandparents, there are several gifting strategies they may want to consider that could reduce the size of their taxable estate.

But *how* they give can also impact the student's eligibility for financial aid, or worse, impact their own ability to qualify for Medicaid later in life.

"You must be very careful and plan your gifts according to your particular situation," said Peter Lang, president of Lang Capital in Bluffton, South Carolina, in an interview. He noted a grandparent should consult a financial professional or tax advisor before they give to minimize any unintended consequences.

Pay Tuition Directly to School

Wealthy individuals who are mindful of staying below the lifetime estate and gift tax exemption limit, which is $5.45 million for 2016, for example, should think twice about giving their "grands" a chunk of cash for college, said Thomas O'Connell, president of International Financial Advisory Group in Parsippany, New Jersey.

By writing a check directly to the college to cover their grandchild's tuition, instead, that money would be removed from the donor's taxable estate and would not be counted towards their lifetime gift and estate tax limit.

According to the IRS, tuition that you pay for someone else is exempt from the federal gift tax.

There is no limit to how much you may contribute towards your grandchild's tuition, said O'Connell, but the special gift tax gift exclusion only allows donors to pay for college tuition. It does not cover books, supplies or room and board.

As such, if you are looking to provide a full ride, you can separately give up to the annual gift tax exclusion limit to each college-bound grandchild to cover the rest of their tab. That limit for 2016 is $14,000 per year, or $28,000 if you are married and your spouse donates, too.[1]

One word of caution: If you pay tuition directly to your grandchild's school, it may have a negative impact on the student's eligibility for financial aid. It all depends on the college or university. (Related: College Financial Aid Primer)

Savingforcollege.com reports financial aid formulas may treat the direct payment as a dollar-for-dollar reduction in aid eligibility for the following year. The tuition payment may otherwise be treated as student income on the next year's Free Application for Federal Student Aid (FAFSA), which would reduce aid eligibility by 50 percent of the amount paid.

Start Your Own 529 College Savings Plan

Contributions to your grandchild's 529 college savings plan are treated as a gift to the beneficiary for tax purposes, but qualify for the $14,000 annual gift tax exclusion.

Grandparents (or anyone) who prefer to make a larger one-time contribution can gift up to five years' worth of the annual gift tax exclusion limit all at once, said Lang. That does not mean they can contribute more tax-free than those who gift annually, however. Individuals who choose to make five years' worth of gifts in a single year would not be eligible to make annual exclusion gifts to that grandchild until the five years is up.

The MassMutual College Cost Planning calculator can help you determine how much your grandchild will need for college.

Money in a 529 plan grows tax free while in the plan, and distributions are also tax free if used for qualified education expenses.

The earnings, however, will be subject to ordinary income tax, plus hit with a 10 percent penalty, if the money is withdrawn for any other purpose. The penalty, not the income tax, is waived in certain cases, including if the beneficiary dies or becomes disabled, receives a scholarship or attends a U.S. Military Academy, according to the IRS. College savings 529 contributions can also potentially undermine the student's eligibility for financial aid, as assets in accounts owned by a dependent student or one of their parents are counted as a parental asset on the FAFSA.

Generous grandparents may instead opt to open a 529 in their own name for use by their grandchild, said O'Connell. Contributions to the account are removed from their taxable estate, and would not be counted as a student asset on the FAFSA *while it remains invested*.

Once the money is used to pay for college costs, it is fair game for financial aid calculations, which could have an adverse outcome on the student's financial aid eligibility the following year. This is because distributions from a 529 plan owned by someone other than the student or their parents are generally considered to be student income.

For that reason, O'Connell suggests grandparents leave the money in their 529 untouched until their grandchild (the beneficiary) has started their last year of college.

"You just have to be careful how you do it," said O'Connell. "A lot of times we suggest to grandparents that they save all their money up and pay college tuition in the last year so their grandchild doesn't have to worry about filling out the FAFSA application again. Plus, their account gets a few extra years to gain earnings that way."

Just be sure to keep an eye on the coming bills and your account balance. If you over-save, any earnings not used for qualified education purposes will not only be taxed at your ordinary tax rate, but hit with the 10 percent penalty. If you have other grandchildren, however, you can avoid the penalty by transferring any remaining funds in your 529 account to that grandchild's name for use in covering their own college expenses.

Another important point for grandparents who opt to open a 529 in their own name is that the money in their account may be considered an available asset when testing for Medicaid eligibility, the federal-state health insurance plan for low-income and disabled individuals. Depending on their state of residence those assets may need to be spent down before they would qualify for benefits. An elder law attorney can help guide you.

Permanent Life Insurance Policy

Permanent life insurance, a category that includes whole life and universal insurance , is primarily designed to provide a death benefit to your beneficiaries. Because they also offer a cash value component, however, such policies could also help fund your grandchild's college education, said Lang. Unlike savings in a 529 plan, assets in a life insurance policy owned by the student or their parents are generally excluded from financial aid formulas, according to the U.S. Department of Education. If they cash out the policy, however, those funds can be considered on the FAFSA. Keep in mind, though, that private financial aid may have different rules for whether funds can be excluded.

Flexibility is another perk. While 529 plan assets must be used for qualified education expenses, or incur taxes and a 10 percent penalty, the cash value in your permanent life insurance plan can be used for whatever you wish, including college tuition, the down payment on a first-time home, or supplemental retirement income.

"If you purchase whole life or universal life insurance for the child when they're born, then the child can withdraw a portion of that cash value as a loan for educational purposes when they reach college age, which is usually nontaxable," said Lang.

Policyowners are responsible for repaying a policy loan, either personally or out of the policy's proceeds when the death benefit is paid out or the policy lapses. Be forewarned: Interest will accrue on outstanding loans. If the policy lapses, the total policy debt (loans plus unpaid accrued interest) is considered a taxable distribution.

Policy owners should be aware, too, that taking partial surrenders and/or loans will reduce their or accruing loan interest may significantly erode policy values over time, and may cause the policy to lapse. (Related: Treating Cash Value with Care)

It may be advisable to speak with a financial professional to determine whether permanent life insurance can help meet your financial goals, and explore alternatives.

Irrevocable Trust

Grandparents can also set up an irrevocable trust with college tuition money and name their grandchild as the beneficiary. (The child's parent would generally be named the trustee if he or she is still a minor).

In doing so, the assets are permanently removed from the grandparent's estate, which reduces the tax implications to their future heirs, and disregarded for Medicaid eligibility purposes, as long as the transfer is made at least 60 months (5 years) before the grandparent needs the program, said Lang.

(Any money transferred to the trust within the last 5 years would be subject to the "look back rule," which may disqualify the donor from Medicaid eligibility for a period of time).

Here again, however, it can impact the student's ability to secure need-based financial aid, as most trusts are counted as a student asset in the financial aid process, according to FinAid.org.

Another negative? While the trust creator can set forth rules and guidelines for use of the trust assets, and when the funds should be distributed, they also lose control of those assets, which some individuals find tough to swallow, said O'Connell.

Grandparents who are looking to pay for their grandchildren's education costs — either in part or in full — are welcome in any family.

To maximize their generosity, however, and prevent unintended consequences to financial aid and Medicare eligibility, they perhaps should speak first to a financial professional.

"These strategies are neither good nor bad," said O'Connell. "It just depends on what is appropriate based on their individual goals and objectives."