Funding the Grandkids' Education

By Carla C. Wigen and Monica Padineant

CARLA C. WIGEN, JD, CPA

Carla is chief operating officer at Laird Norton Wealth Management. She has more than 20 years of experience in wealth management, focused on trusts and estate planning.

MONICA PADINEANT, CFP®

Monica is a director, client services at Laird Norton Wealth Management. She has nearly two decades of experience building wealth plans for clients that consider all aspects of their lives and finances.

Education is a top priority for many of our clients, including ones who are grandparents and see education as the ultimate gift to the younger generations in the family. While paying for the grandkids' education can be extremely fulfilling in and of itself, it is also a gift that can play a role in effective estate planning. So we thought we would run through the pros and cons of the major funding options. Keep in mind that you can do some or all these things; they are not mutually exclusive.

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 — none of your payments are counted in terms of gift or estate taxes.

What about room-and-board and any other non-tuition expenses? Parents can pay all types of education costs for dependent children without tax consequences. But the tax situation is a bit different if you're a grandparent. That's because non-tuition payments are considered a gift (not a necessity). Gifts up to $16,000 annually per recipient (indexed for inflation) are not reportable to the IRS. But if you exceed that amount, the IRS wants to know about it (see box bottom of page).

Tax-Advantaged 529 Savings Plans

If you have time to plan ahead — when the grandkids are in diapers or in K-12 — you have more options. Section 529 Savings Plans, for example, allow you to front-load up to five years' worth of education funding — so $80,000 total ($16,000 x 5) or $160,000 if both you and your spouse are giving — without gift-tax consequences. And you can do this every five years.

FOR EXAMPLE: If you have four grandchildren and front-load 529 Plans for each of them over a decade, a total of $1.280 million will not be counted as part of your estate and can be used to fund education.

What's a Reportable Gift?

The IRS wants to know about gifts you make that are more than $16,000 annually to each recipient ($32,000 if you and your spouse are both giving). The only two things not considered gifts: tuition payments directly to the institution and medical cost payments to the provider. What happens if you go over the annual gift cutoff? You are then required to report the gift to the IRS (Form 709), and the overage is deducted from your lifetime estate tax exclusion, which is currently $12.06 million per person (indexed for inflation).

Note that many 529 plans have $500,000 funding limits per beneficiary, but some cap at around $200,000.

What if the 529 Plan money isn't used for education? On the withdrawal amount that is income and capital gains (not principal invested) you'll pay a 10% penalty in addition to the regular taxes. In certain circumstances, the 10% penalty can be waived: If the beneficiary attends a US military academy or receives one or more tax-free scholarships (you can withdraw up to the scholarship amount for non-education expenses) or if the beneficiary becomes disabled or dies. Beyond that, 529 Savings Plans allow for a great deal of flexibility:

- **They can fund most types of education, not just college or graduate school.** For K-12 tuition, up to $10,000 annually can be withdrawn tax-free. Expenses at a registered apprenticeship program qualify. And up to $10,000 total over the recipient's lifetime can be used to pay off student loans.
- **You can change the beneficiary at any time as many times as necessary.** The beneficiary can even be you, the account holder. If kids are not able to go to college or defer college, assets in the 529 Plan can be transferred to siblings, parents, or anyone else who is a family member, including in-laws, aunts, uncles, cousins, nieces, nephews.
- **Money in 529 Savings Plans can be rolled into a 529 ABLE Plan** (up to $16,000 annually). This is important for beneficiaries with special needs who might also have assets in a Special Needs Trust. A 529 ABLE account can be funded with up to $100,000 total and not disqualify the recipient from government assistance; withdrawals can be used to pay for living expenses, healthcare and other needs.

Two Types of 529s

529 College Savings Plans: Tax-advantaged investment accounts with limited investment options (usually balanced index funds) and not guaranteed to cover tuition. Withdrawals can be used to pay for a variety of education expenses in addition to tuition, and contribution limits often exceed $300,000. You can invest in the 529 Savings Plan sponsored by any state, so it pays to compare fees, investment offerings, and performance. A great resource for that is www.collegesavings.com.

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.

Custodial Accounts

Custodial accounts can work really well as teaching tools and to fund major goals. Technically known as UTMAs and UGTAs (under the Uniform Transfers to Minors Act or the Uniform Gift to Minors Act), they can be started when children are very young and used to teach them about money management as they age. However, make sure you know what the rules are:

1) These are irrevocable custodial accounts in one child's name, and this cannot be changed.
2) The account is subject to the "Kiddie Tax" on investment income. For income (dividends, interest, and capital gains realized when selling at a profit), the first $1,150 is tax-free; $1,151 to $2,300 is taxed at the lowest income-tax bracket. Any income over $2,300, however, is taxed at the parent or guardian's highest marginal tax rate.

3) The money can be used for anything that benefits the child, not just college.

4) At a relatively young age – either 18 or 21 depending on state of primary residence –- the child will become legal owner of the account and can do with the assets as they please.

In their teens, children can start learning how their custodial account is invested, and how to save and plan for long-term goals. Sometimes, clients will put money into a custodial account and have their children or grandchildren work with us on managing it. This process can be educational and empowering for the kids while creating opportunities for the different generations to talk about money in relation to life goals and values.

When a Trust Makes Sense

If you have grandchildren and a large estate, and you want to control who will get money for education, and when they'll get it, 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 funding options, including working part-time.

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.

Getting Started

Education is an asset with high long-term returns, financial and personal. To discuss how best to fund education within your family or even in the community through philanthropy (a foundation, Donor-Advised Fund or other types of giving), please reach out to your LNWM advisory team.

ABOUT THE AUTHOR

Carla C. Wigen, JD, CPA is chief operating officer at Laird Norton Wealth Management. She has more than 20 years of experience in wealth management, focused on trusts and estate planning. At LNWM, Carla is responsible for ensuring that all of LNWM's expertise and resources are applied to further each client's goals and continue to evolve to meet the changing needs of our clients. Carla earned a Juris Doctorate at the Seattle University School of Law and a Master's of Law at the University of Washington School of Law. She has a Bachelor's in Business Administration from the University of Washington and is a Certified Public Accountant.

Monica Padineant, CFP® is a director, client services at Laird Norton Wealth Management. To her work she brings nearly 20 years of experience in financial services, including the creation of customized and integrated wealth strategies, that include legacy, philanthropic planning and impact investing. As head of LNWM's NextGen Money Group, Monica leads workshops and presentations that help the younger generations in client families assume financial responsibility. She is a CERTIFIED FINANCIAL PLANNER™ professional and holds a bachelor's degree in business administration from the University of Washington.

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801 Second Avenue, Suite 1600, Seattle WA 98104   206.464.5100   800.426.5105   lairdnortonwm.com

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