STRATEGIC EDUCATIONAL FUNDING FOR THE NEXT GENERATION

As the cost of education grows, so does the importance of putting a plan into action.

For anyone who hopes to maintain at least a middle-class lifestyle, a degree from a higher education institution has become a must. As parents and grandparents, we want to see children succeed but may worry how the education will be funded and by whom. It is especially nice that as the cost of college keeps growing, those who have the means take the initiative to help pay for education. Whether it's parents or grandparents, there are many ways to help save and pay for education and those thinking about it should be aware of the different options available. The most common approaches include 529 plans, custodial accounts, direct gifting to the individual, and direct payments to an educational institution.

529 Plans

A 529 plan is an education savings plan in which the investment grows tax-deferred and distributions used for qualified post-secondary education are free of federal tax. This type of savings plan allows the owner to often change the beneficiary and investments as they choose and provides a variety of funding options. In addition, 35 states give the 529 owner at least a partial tax deduction for all contributions made to the plan. The owner can contribute to a 529 plan as a gift without incurring penalties by taking advantage of annual federal gifting limits. One of the advantages of these plans includes the fact that 529s can be funded with 5 years' worth of future nontaxable gifts. While contributions to a 529 are a completed gift (and hence remove the funds from your estate), the owner has access to the funds. Any withdrawals, however, will be subject to a tax and a 10% penalty on earnings if the money is not used to pay for education. Those who consider these plans should also be aware that many plans tend to have high fees and limited investment options.

Custodial Accounts

Another way to save for future education is through a custodial account often known as a UTMA or UGMA account. This account is similar to an individual investment account but gifts made to it are held in trust until the child reaches the age of trust determination (age 18 or 21 depending on the state in which it is opened). While these are very easy to open and manage, there are several drawbacks associated with this type of account. The assets in a custodial account belong to the student and may count against them if they apply for college financial aid. Investment income generated by the custodial account must be reported on the child's tax return and is taxed at the parents' rate. And finally, it's very important to consider that the funds in a custodial account are irrevocable and once the child reaches adulthood, they are free to access the funds as they choose.

Direct Payments

Federal gifting rules currently allow a parent or grandparent to make a direct gift of up to $19,000 per year to anyone without reporting it separately. Also, this amount will not be deducted from your lifetime federal gift and estate tax exemption, and you can make gifts of up to $19,000 to as many people as you choose. Married couples can give $38,000 per recipient without any gift tax ramifications, though they must report to the IRS that they have combined gifts.

If funds are paid directly to a qualified educational institution, however, there is NO limit to the amount you can give. This type of direct payment will incur no gift tax, and nothing will be deducted from your lifetime exemption amount. This applies only for the payments made directly to the institution. If you also wish to cover other costs, such as books or off-campus room and board, that may need to be paid separately. This educational expense tax exemption may be very desirable for successful families. Those that are looking for ways to reduce the potential value of an estate may appreciate the opportunity to make unlimited direct payments to educations institutions.

> "The owner of a 529 can take advantage of annual federal gifting limits without incurring gift taxes."

Choosing Strategies

Savings strategies must fit the family and the finances. The downside to contributing money to a custodial account is that a grown child may decide not to go to college. For this reason, a separate joint investment account in the parents' names or a 529 account may be the best choice to start for a young child's educational savings plan. Funding a joint account doesn't put the funds in the child's name, but it avoids any gift considerations and still can earmark the savings.

This is an especially good strategy if grandparents one day help finance a future education. Then when the time comes for grandparents to help financially, the money saved is available for other priorities. Any direct gifting to the child can be used to finance other college expenses, such as books or room and board.

Try Not to Make Promises

Regardless of the method you choose, there are non-financial issues to consider. Is college right for the child? Will giving a gift to a child 10-15 years from now still be desirable as well? While it is admirable to give the gift of education to grandchildren, one should also consider the unintended consequences of promising to pay for grandchildren's education. If a promise has been made to pay for education, is this

> Any payment made directly to an educational institution doesn't count as a gift.

giving a signal to the parents that they don't need to save for their children's education? Since they know this major expense will be covered, will this be creating a sense of entitlement or inhibiting their motivation to succeed?

Recent reports have found that 80% of millionaires are first generation (not inheritors), and that many tend to live beneath their means while their inheriting children are more likely to spend more than they earn and not save. Rather than allowing young parents to believe they don't have to save for their child's college expenses due to an expected educational gift, it is highly recommended to avoid making future promises. Instead, set aside money and pay it directly to the institution when the grandchild reaches college age. This way, there are no expectations by the parents and they have time to put their own savings plan into action for their children's future.

Here are a few ways a grandparent might approach paying for their grandchildren's education without making promises that can have detrimental effects.

1. Don't make specific promises to your adult children regarding funding your grandchildren's college education. Instead, perhaps tell them you hope to help when the time comes.
2. Offer to match college savings that your children set aside.
3. Share what your strategy for saving and paying for college was when your children were young.
4. Talk to your grandchildren about why you have chosen to pay for school. Discuss both the financial and educational value reasons.

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