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Paying Grandkids' College Bill

By KELLY GREENE APRIL 30, 2011

Recent tax-law changes are making it easier for families to help pay education bills for multiple grandchildren and even future generations. But grandparents have to make some tough decisions first.

Under the Tax Relief Act of 2010, the federal gift-tax exemption increases to $5 million from $1 million for individuals, as does the exemption for the generation-skipping tax. The latter tax is imposed when givers try to avoid layers of estate tax by leaving assets to heirs two or more generations removed.

Mark Matcho

The changes make it easier to pass along money for education to future generations free of taxes—at least through 2012, after which the exemption is scheduled to revert to $1 million. A married couple, for instance, can use their combined $10 million exemption to avoid federal gift and generation-skipping taxes.

"The phone just keeps ringing," says Jessica Galligan Goldsmith, an estate-planning attorney and partner at Kurzman Eisenberg Corbin & Lever in White Plains, N.Y. "I'm talking many clients through the possibilities right now."

Driving many families' interest is the skyrocketing cost of a college education. Harvard University, for example, increased its undergraduate tuition by 3.8% for 2011-12, with tuition, fees, room and board now topping $52,000 a year. Many state schools aren't cheap, either: Costs for in-state freshmen at the University of Michigan are estimated to be about $24,000 in 2011-12.

Until now, there were two big tax breaks that grandparents could tap: They could—and still can—pay an unlimited amount of tuition directly to an accredited school for their grandchildren's education without incurring any gift tax or using their exemption. Some schools, including Harvard and New York University, are even locking in tuition for families who pay for all four years upfront, says

Deborah Fox, founder of Fox College Funding in San Diego, though not all families will be comfortable doing so. (If you go this route, make sure you can get a refund if the student drops out or transfers, she advises.)

Also continuing is the annual gift exclusion, which, separately from the gift-tax exemption, lets each individual give up to $13,000 to an unlimited number of people each year free of tax.

Grandparents typically use that money to set up a custodial account for a grandchild or to fund a 529 college-savings plan. (More on that later.) The problem with custodial accounts, many grandparents worry, is that the cumulative amount, which could top $250,000 over a decade, is too much for grandchildren to have at their disposal at age 21.

Now, with the larger tax exemptions, Ms. Goldsmith is seeing more grandparents turning their attention to college funding for grandchildren who are mere toddlers—or who aren't even born yet. In that case, trusts earmarked for education expenses may better meet a family's goals, she says, since the grandchildren may not reach college age until after the grandparents die.

In families with multiple grandchildren and the potential for more, Ms. Goldsmith often recommends setting up a "pot trust," or dynasty trust, which names all of the grandchildren, including any future babies, as beneficiaries. The length of such a trust varies by state but generally can serve at least a few generations of college students.

How do you choose a trustee for a trust that will outlive you? Ms. Goldsmith typically advises parents to name a family member who isn't benefiting from the trust, such as an uncle or cousin, who can then hire a professional investment adviser if necessary. If you don't feel comfortable with one lump trust, you could instead set up a trust for each grandchild, or each grandchild and their future children, she adds.

Of course, a trust owes income tax on its earnings. But grandparents can pay those bills during their lifetime, essentially making an additional tax-free gift to the grandchild. "It's another way to leverage your tax-free giving," Ms. Goldsmith says.

One important caveat: An irrevocable trust—the type that grandparents typically set up—has to be reported on a student's financial-aid form. Even if the trust doesn't provide any income until after college graduation, financial-aid officers often count it anyway. "We're dealing with a lot more families who make six figures but will still qualify for need-based aid," she says. "These trusts are killing their kids' chances."

The only kind of trust that doesn't have to be reported as an asset on the Free Application for Federal Student Aid is a court-ordered involuntary trust, such as a trust to pay future medical expenses of an accident victim, says Mark Kantrowitz, founder of FinAid.org, a financial-aid website.

If you aren't trying to foot the entire bill, consider contributing to a 529 plan instead. Such plans let people save for higher education, with withdrawals used for college expenses generally tax-free.

Assets you contribute to a 529 account are no longer part of your estate. If you are the account owner, you can withdraw the assets later without penalty, and the money doesn't have to be reported on the grandchild's federal aid form.

When the assets are withdrawn, though, they will be counted as the student's income, Ms. Fox says. She recommends moving the account to the parents' names by the time the student is enrolled, since the withdrawals would be counted as a much smaller part of their income for financial-aid purposes.