How Grandparents *can help* Fund College

A Fidelity article presented by: JohnsonBrunetti RETIREMENT & INVESTMENT SPECIALISTS

How grandparents can help fund college

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Key takeaways

- The 529 college savings plan offers an appealing combination of tax advantages, control, flexibility, and minimal impact on student aid.
- Determine much control you want to retain over the money you gift to grandchildren.
- Consider the importance of potential tax breaks in your gifting decision.

Many grandparents naturally want to help prepare their grandchildren to have a great future, and helping to fund their education is a favorite route. According to Fidelity's 2014 Grandparents and College Savings Study,[1] 72% of grandparents think it’s important to help pay for their grandchildren's college, and more than half (53%) of those surveyed are currently contributing or are planning to do so.

As parents, how can you help your own parents play a role in your child’s future by their contributions to his or her college savings?

Step one is to start a family conversation. Begin by focusing on goals. What are your child's educational aspirations? How would your parents like to help? How much control do they want to retain over the money and how it is spent? How important are tax breaks and investment option choices? Who will invest the money so it can grow? This kind of open discussion will make it easier for your family to decide the strategy and type of account that works best for all.

There are a number of strategies for grandparents to help, including the three tax-advantaged savings options below. Consider how they might impact the whole family: grandparents, the grandchildren, and you.

529 plans[2] offer flexibility, control, and generous tax breaks.

The 529 college savings plan offers an appealing combination of tax advantages, control, flexibility, and minimal impact on student aid.

The pros

- **Tax advantages.** The contributions you make to 529 plans are after-tax. But earnings and withdrawals are federal income tax free when you use them for qualified higher education expenses. This includes tuition, books, fees, supplies, and other approved expenses at accredited institutions. In addition, once the annual gift has been made to the 529 plan, the money is no longer considered part of the parents' or grandparents' estate, for estate tax purposes.[3]
- **Control.** When you open a 529 account with a child or grandchild as beneficiary, you maintain control of the account, which lets you decide when to disburse the proceeds; you can even decide to change the beneficiary if you wish.[4] A grandparent can open a 529 and maintain total control, or gift to an account opened by you, as parent, and you maintain control.
- **Front-loading of college savings.** You can front-load a 529 plan (giving five years' worth of annual gifts of up to $15,000 at once, for a total of up to $75,000 per person, per beneficiary) without having to pay a gift tax or chip away at the lifetime gift tax exclusion.[5] Of course, that means the grandparent can't make any more excluded gifts to the grandchild during those five years. Also, if the grandparent dies during that five-year period, the contributions for any remaining years would be brought back into his or her estate.
- **Minimal impact on financial aid.** If grandparents contribute to the parent's 529 college savings plan, the money is considered a parental asset when calculating the Expected Family Contribution (EFC) for federal financial aid. So, they count for up to 5.6% of assets versus 20% for a student asset, which is how they would be counted for an UGMA/UTMA account.
- **One financial aid catch.** A 529 account held by a grandparent isn't included as a parental asset in the federal EFC calculation. However, once the money is distributed, it is considered student income, which can have a significant negative impact on financial aid.

The cons

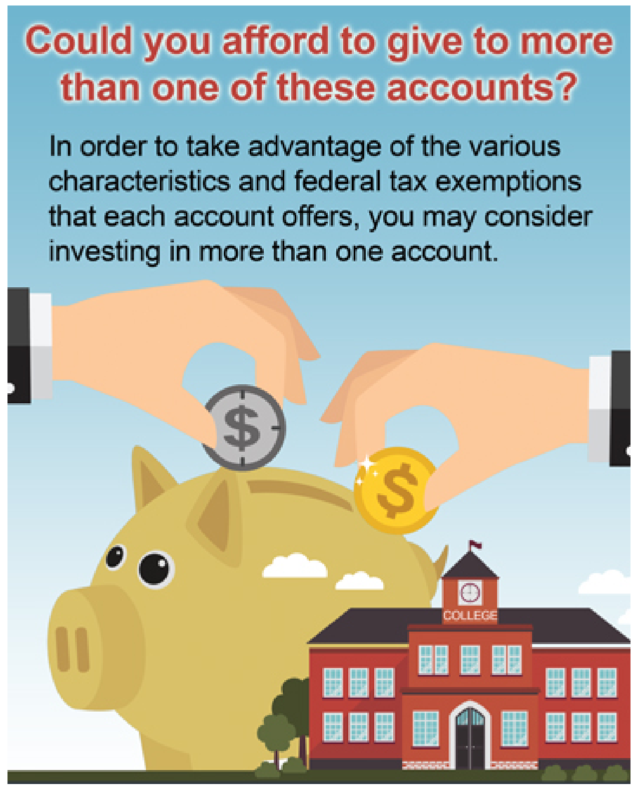
- **Limited investment options.** 529 plans typically offer a selection of investment options, often including age-based funds that automatically become more conservative as the beneficiary approaches college age. However, the range of options is not as broad as those available in Coverdell ESAs or UTMA/UGMA brokerage accounts. For example, you cannot invest in individual stocks through a 529 plan.
- **Penalties on certain withdrawals.** You can withdraw the money yourself at any point. However, be prepared to pay income taxes on any earnings, plus a 10% penalty on those earnings if the money is not used for qualified higher education expenses.
- **Medicaid implications.** A major drawback to ownership of a 529 plan account for grandparents who aren't that well off is the possible loss of Medicaid assistance. The

529 plan account balance would have to be spent on your care before Medicaid payments could begin.

"The 529 plan is a particularly attractive savings option for younger children because of the front-loading option and the long-term market growth potential," says Ajay Sarkaria, a senior wealth planning specialist at Fidelity Investments. "They also provide a vehicle for tax-free gifting."

UGMAs/UTMAs offer more investment options but less control.

A parent or grandparent can use a Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) account (i.e., "custodial" account) to save for a child, but the child named on the account would gain control once he or she reaches a specified age. So, you would need to be ready to give up control of the money.



The pros

- **Broad investment options.** While the loss of control might be a disadvantage to many parents or grandparents, the greater range of investment options in a custodial account versus a 529 plan could be attractive to a knowledgeable, self-directed investor.
- **No limit on contributions.** You can contribute virtually any type of asset, for any amount, on both UTMAs and UGMAs. In the case of UTMAs, you can even contribute real estate. Note, though, that taxes may apply, so you should consult with a tax attorney or accountant before making a contribution.

The cons

- **Loss of control.** The custodian controls the account until the child reaches a specified age, typically 18 or 21 (rules vary by state). Once the account beneficiary reaches that age, he or she can use the money for anything. This might be a concern for people who fear that the beneficiary might spend the money unwisely or on noneducational materials.
- **Potential for less student aid.** Because custodial accounts—such as UGMA and UTMAs—are counted as a student's asset, they are generally factored into the EFC at 20%, which is much higher than the 3%–5.6% factored in for parental assets.
- **Modest tax benefits.** The interest, dividends, and capital gains each year from the

UTMA are reported under the child's Social Security number. If the child is a minor (or full-time student under age 24), the first $1,050 earned in 2017 is tax exempt. The next $1,050 is taxed at the child's tax rate, typically lower than the parents'. Any yearly earnings above $2,100 are taxed at the parents' rate. However, all withdrawals face taxes on capital gains. Also, unlike 529 plans, UTMA/UGMA accounts are included in the estate of the account's custodian (parent or grandparent) for estate tax purposes.

Coverdell ESAs offer tax-free savings but are limited.

Coverdell Education Savings Accounts (ESA) offer a tax-deferred and potentially tax-free savings option if used for college expenses or other education expenses, from kindergarten through college. But eligibility and contributions are limited. As of November 2, 2017, the proposed tax reform legislation called for significant changes to the standard deduction and various itemized deductions for tax years after 2017. (Note: Fidelity does not offer Coverdell ESAs.)

The pros

- **Broader uses.** Coverdell ESAs can be used to save for education expenses, from kindergarten through college.
- **Tax benefits.** Earnings and withdrawals are tax free if used for qualified expenses for taxpayers who don't claim an American Opportunity credit or Lifetime Learning credit for the same expenses in the same year. In addition, once the annual gift has been made to the Coverdell ESA, the money is no longer considered part of the parents' or grandparents' estate for estate tax purposes.
- **More investment options.** Coverdell ESAs also have a greater range of investment types that are eligible to be contributed to, or purchased by, these accounts, which could be attractive to a knowledgeable, self-directed investor.

The cons

- **Lower contribution limit and possible confusion.** Coverdell ESAs have a low annual contribution limit of $2,000. This is the total amount that all individuals can contribute to one account—or to multiple Coverdell accounts for the same beneficiary—in any year. Unless all family members know what others are contributing and how many accounts have been opened, it could be easy to make an excess contribution. In that case, the holder of the account would owe a penalty.
- **Limited eligibility.** Coverdell's have income limits for contributions. The ability to contribute to a Coverdell ESA begins to be phased out for single tax filers with modified adjusted gross income (MAGI) of $95,000, and the ability to contribute ends at MAGI of $110,000; joint filers are phased out with MAGI of $190,000 to $220,000.
- **Loss of control.** Most ESAs require the child's parent or guardian to be responsible for the account. In losing control of the account, a grandparent would no longer have the option of transferring the money to a different beneficiary, or of withdrawing the money if needed for other purposes. That said, there is no law that prevents a grandparent from

opening a Coverdell account.

Another approach for parents and grandparents may be to combine the features of custodial accounts and 529 college savings plans. For example, by placing a 529 plan within a custodial account, the parent or grandparent can retain control until the student becomes of age (generally 18 to 21, but varies by state). After that, the student would have control, but must use the money for college expenses or pay a penalty. "This would allow you to receive tax-deferred growth and spend the money tax free on college expenses, plus it would ensure that the student receives the money no matter what," says Keith Bernhardt, vice president of college planning at Fidelity Investments.

Alternatively, grandparents can pay for college directly. For estate-planning purposes, the advantage of paying directly is that it is not considered a gift. So, a grandparent could still use his or her annual gift exclusion to give up to $15,000 to the same grandchild. The downside is that a direct tuition payment could reduce subsequent financial aid dollar for dollar.[5] Also, you would lose the advantage of years of tax-advantaged savings offered with a 529 plan or a Coverdell ESA.

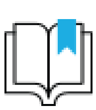
What is the right solution for you?

For many grandparents looking for a tax-smart way to contribute to their grandchildren's education, 529 accounts may prove to be an attractive education funding vehicle. But it's not right for everyone. So think through your personal situation with your loved ones. If you need help, work with a financial consultant. And enjoy the process of building your family's someday together.

Next steps to consider

Save for college
Open a flexible, tax-advantaged 529 college savings plan.

Check to see if you're on track with our college savings calculator.



ABCs of 529 plans
Learn how college savings plans work, including tax savings.

Please carefully consider the plan's investment objectives, risks, charges, and expenses before investing. Contact Fidelity for this and other information on any 529 college savings plan managed by Fidelity, call or write to Fidelity for a free Fact Kit, or view one online. Read it carefully before you invest.

1. Fidelity Investments, '2014 Grandparents and College Savings Study,' June 2014.

2. 529s have aggregate account limits that vary by state.

3. In order for an accelerated transfer to a 529 plan (for a given beneficiary) of $75,000 (or $150,000 combined for spouses who gift split) to result in no federal transfer tax and no use of any portion of the applicable federal transfer tax exemption and/or credit amounts, no further annual exclusion gifts and/or generation-skipping transfers to the same beneficiary may be made over the five-year period, and the transfer must be reported as a series of five equal annual transfers on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. If the donor dies within the five-year period, a portion of the transferred amount will be included in the donor's estate for estate tax purposes.

4. See a Fact Kit for more details on changing beneficiaries.

5. Savingforcollege.com, College Savings 101, "For grandparents."

The UNIQUE College Investing Plan, U.Fund College Investing Plan, Delaware College Investment Plan, and Fidelity Arizona College Savings Plan are offered by the state of New Hampshire, MEFA, the state of Delaware, and the Arizona Commission for Postsecondary Education, respectively, and managed by Fidelity Investments. If you or the designated beneficiary is not a New Hampshire, Massachusetts, Delaware, or Arizona, resident, you may want to consider, before investing, whether your state or the designated beneficiary's home state offers its residents a plan with alternate state tax advantages or other state benefits such as financial aid, scholarship funds and protection from creditors.

Units of the portfolios are municipal securities and may be subject to market volatility and fluctuation.

Investing involves risk, including risk of loss.

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