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Consider a 529 Plan to Help Cover College Costs for Grandchildren

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Chase Mouchet, CFP®, CIMA® [1] | Wealth Advisor

As graduation season approaches, the rising cost of a college education becomes more top of mind for many parents and grandparents. A 2015 Gallup survey indicated that over 73% of parents identified paying for college as their top financial worry. And according to a 2018 AARP study, nearly one in five (21%) grandparents assist with college costs. With the continuing rise in record student loan debt levels, many grandparents want to better understand how to plan for their grandchildren's college costs without them having to incur burdensome debt.

For grandparents revisiting or starting a college funding plan, a state-sponsored 529 college savings plan could be a worthwhile option. It offers tax-free growth, is low maintenance and provides flexibility in how the savings are used if family circumstances change.

Below are five key features of 529 plans that every grandparent should consider as they balance their resources and goals with their grandchildren's college education:

They offer unique tax advantages over other savings vehicles. Money in a 529 plan grows tax-free and isn't subject to income taxes if used for qualified higher education expenses. These expenses include undergraduate and graduate school tuition, textbooks, meal plans, laptops, and room and board (if the student is enrolled at least half-time). If the grandchild receives a scholarship and funds are used to cover costs outside of education, the earnings are only taxed at ordinary income rates without penalty. A good option for any unused funds may be to redirect them to another grandchild to preserve the tax advantaged status.

Over 30 states offer tax breaks to residents who contribute to their state-sponsored plan.

Georgia provides a state income tax deduction on contributions up to $8,000 per beneficiary to the state's Path2College 529 plan. A few states offer an income tax deduction even if the resident contributes to another state's plan. If a grandchild is nearing or already attending college, a grandparent or other family member could still consider setting up an account to capture the state tax deduction.

Low maintenance, age-based investment choices automatically reduce the investment risk as the grandchild nears college. If the 529 plan is started when the grandchild is four years old, funds could be allocated for growth. As the grandchild gets closer to entering college, the age-based allocation would become more conservative, which could provide further protection in case of a market downturn. Alternatively, many states allow 529 plan owners to select specific funds or a static portfolio that does not change until the account owner makes a switch. However, 529 plans are not intended to be a vehicle for frequent investment moves; changes are only allowed twice per year per beneficiary.

They can offer an effective way for grandparents to leave a legacy by earmarking assets to help pay for college. Although 529 plan contributions count toward the $15,000 per person annual gift tax exclusion limit, a unique rule allows donors to effectively front-load up to five years' worth of contributions and avoid gift taxes. For example, a grandparent couple could contribute up to $150,000 in year one toward their grandchild's 529 plan and not pay taxes or use a portion of their estate exemption. Additionally, 529 plan assets are not included in the estate of the account owner. Contributions can either be made to a 529 plan owned by the grandparent or directly into the parent or grandchild-owned 529 plan, depending on factors such as family circumstances and financial aid considerations.

It is important to note that states do have 529 plan funding limits and overfunding the account could create negative tax consequences if the funds are not used for college. Talking with your family to understand the scope of need could also help you arrive at an appropriate funding amount.

A 529 plan can supplement financial aid, but there are a few strategies to keep in mind depending on who owns the account and the timing of distributions. For students who need to apply for financial aid, the Free Application for Federal Student Aid (FAFSA) treats 529 plan assets and withdrawals favorably compared to many other assets. Although money in a parent or student-owned 529 plan is reported on the FAFSA, withdrawals are not counted against financial aid eligibility. In contrast, investment income from a brokerage account to supplement a financial aid package would need to be reported on the FAFSA, thereby lowering the amount of financial aid.

If a grandparent owns the 529 plan, the rules are different: the account balance does not get reported on the FAFSA, but withdrawals are considered student income – which could reduce the amount of financial aid by up to 50% of the amount of the distribution from the grandparent-owned 529 plan. Therefore, family members should strategically manage distributions especially during the earlier college years to lessen the financial aid impact on the student.

As grandparents weigh the advantages of a 529 plan, they should balance their own retirement goals with the costs of paying for college. A 529 plan can be a great tool to help contribute toward a college education for grandchildren due to its tax-advantaged features, ease of use, and flexibility if circumstances change.

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