The right way to help your grandchildren with college

The wrong way could inadvertently hurt your grandchild's prospects for financial aid—or earn lousy returns

Beth Braverman (https://considerable.com/contributor/beth-braverman/) | July 25, 2018

Investing in Your Grandchild's Education 101: Please take a seat, the class is about to start.

As the cost of college continues to climb—tuition at a typical private school now runs nearly $35,000 a year, according to the College Board (https://trends.collegeboard.org/college-pricing/figures-tables/tuition-fees-room-board-over-time)—one of the most valuable gifts you can give your grandkids is to help with their higher education bills.

Nearly one in five grandparents has made a contribution to their grandchild's college savings account, according to TD Ameritrade (https://www.amtd.com/newsroom/press-releases/press-release-details/2017/For-Millennial-Parents-Supporting-Little-College-Hopefuls-Comes-First/default.aspx).

The best way to provide that assistance, however, is usually more complicated than simply writing a check. Your contributions can have unintended consequences, such as a higher tax bill for you or lower financial aid for your grandchild.

There are bigger potential pitfalls too. Life insurance products that are marketed as college savings plans to grandparents and other family members, often from a trusted child-friendly brand like Gerber, tend to be lousy investments, due to their comparatively high fees and low returns.

“Financial products in general often have very persuasive marketing materials,” says Barbara Marquand, an insurance expert with NerdWallet. “When you couple that with a grandparent wanting to help out a beloved grandchild, then a sales pitch can be especially compelling.”

Your best bet: a 529 savings plan

Kind of like an IRA for college, a 529 plan (named after the section in the tax code that created them) allows you to save for college without paying taxes on any growth in the account. You won’t owe taxes when you take the money out for college either, as long as the funds go to pay qualified educational expenses, such as tuition or room and board.

“These accounts are tax-advantaged and financial aid advantaged,” says Mark Kantrowitz, vice president of research with SavingforCollege.com (http://savingforcollege.com). “And they’re fairly easy to set up.”

You can open an account through a financial services firm or buy directly from the states that sponsor the savings plans (find links to all the plans here (http://plans.collegesavings.org/viewState.aspx)). You don’t have to live in the

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2018 College Savings Survey

TD Ameritrade

state to buy its plan and your grandchild isn't obligated to attend school there either.

You'll give up personalized advice if you buy direct but you're still better off cutting out the middleman. One big reason: Many state-sold plans offer sweet tax breaks on 529 contributions for residents that will reduce the amount of state income tax you owe.

Most of the state plans also have lower management fees, typically less than 1% of the amount you invest vs. 1% to 2.5% for advisor-sold plans. That can make a big difference to how much your account grows.

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Plus, the plans make investing easy: They offer a pre-set mix of stock, bond, and cash investments based on when your grandchild is expected to go to college. The mix gradually becomes more conservative as your grandchild gets older and closer to attending.

Which state savings plan is right for you

To choose among the more than 60 state plans available, you'll want to factor in tax incentives, the cost of the plan, and the range of investment options available.

Of the more than 30 states that offer a tax break on your contribution, only seven extend that benefit to 529 investments made in another state.

"As long as it's a good plan, then go with your home state 529 plan," says Chris Krell, a certified financial planner and principal with Cassaday & Company in McLean, Va.

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> **Chris Krell, certified financial planner**
> Cassaday & Co., McLean, Va.

If your state doesn't offer a tax break on 529 contributions or the plan it offers has high costs (management fees of 1% or more) or bad investment options, look farther afield.

In a 2017 analysis (https://www.morningstar.com/articles/830917/morningstar-names-best-529-college-savings-plans-f.html) of 529 plans, the investment research firm Morningstar gave its highest "Gold" rating to four state-sold plans, based on their low costs, stellar investment choices, and top-notch management. The top-rated plans are Bright Start College Savings (https://www.brightstartsavings.com/) (Illinois), Invest529 (https://www.virginia529.com/new-savers/invest/) (Virginia), the Vanguard 529 College Savings Plan (https://investor.vanguard.com/529-plan/vanguard-529-plan) (Nevada), and the Utah Educational Savings Plan. (https://my529.org/)

Avoid the financial aid traps

Rather than open a 529 account in your name and identify your grandchild as the beneficiary, contribute to an account owned by your child or grandchild instead.

Why do it that way? If the account is in your name, any money withdrawn from the account to pay college bills will be considered student income and up to 50% of it will be counted in the financial aid formula, Kantrowitz says.

If the investment is in the student or parent's name, however, the money is regarded as an asset, not income, and a maximum of just 5.6% is taken into account.

Think of it this way: For every $1,000 you contribute to a college savings plan, schools will count up to $500 against financial aid if the account is in your name, but only up to $56 if the account is registered in a parent or grandchild's

Up to half of college savings may count against financial aid if the account is in a grandparent's name.

Mark Kantrowitz, VP of research

SavingforCollege.com

name.

For grandparents who want to make a large, one-time contribution to college accounts, a 529 also offers a way to get around the legal limit of how much you can give a year without having to file a gift tax return, currently $15,000.

Tax laws allow givers to contribute five years' worth of gifts into a 529 account at once and then claim it over a five-year period. So you can give up to $75,000 in one lump sum contribution; married couples can give up to $150,000 at once.

Steer clear of these strategies

There are, of course, other ways to contribute to your grandchildren's college savings accounts. But none of them offer the tax benefits of a 529 with minimal impact to financial aid.

Giving money directly to your grandchildren, for example, will be viewed as untaxed income and can hurt their financial aid prospects. Paying tuition directly can have a negative impact too since some schools consider tuition payments a "resource," which reduces aid eligibility, dollar for dollar.

One option often heavily marketed to grandparents is purchasing a whole life insurance policy in their grandchildren's name, with the intention of cashing it in when the child graduates high school to help pay for college. Experts advise against this method, since these policies typically come with high fees and lousy returns.

"There are administrative and insurance costs and money that goes to the agent's commission," says Marquand, the insurance expert with NerdWallet. "All of that eats away at the returns."

Case in point: the Gerber Life College Plan, which is marketed with ads featuring the iconic Gerber baby and promises of "guaranteed safe growth." According to a calculator on the Gerber website (https://www.gerberlife.com/gl/planner2011.do), if you save $100 a month in the account for 18 years, you'd earn a guaranteed $25,000 payout.

That might sound swell until you consider how you'd fare with a 529 plan instead. If you invest the same $100 a month with a modest 5% return, your account would be worth around $35,000 after 18 years (figure your projected gains here (https://www.calcxml.com/do/529-college-savings-plan)).

Plus, with a 529 plan, you have flexibility. You can increase payments or stop them for a period of time if you need to, an option you don't have with the insurance-based college savings plans.

You don't need a college degree to know which one is best for your grandkid.

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