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A Better College Funding Strategy Without 529 Plans – The Generous Grandparent Scenario

By Ian A. Post, CFA

Last month, I discussed three do's and don'ts of 529 plans. When used wisely they are a great way to save for college. However, the decision to fund 529 plans should be made as part of an overall financial plan and not in isolation. The following scenario highlights a situation where funding 529 plans can result in a sub-optimal outcome:

Barbara and Sam are financially well-off grandparents who would like to accomplish a significant financial goal: helping their grandchildren with college tuition funding. Barbara and Sam open 529 plan accounts for their grandchildren and fund them each year, often up to the annual gift tax free limit of $14,000 (in 2016, $28,000 using gift splitting).

Recently, Barbara and Sam's daughter, Jennifer, mentioned that she is considering sending Junior to private school but is concerned about the financial commitment that would create. Barbara and Sam would like to help by using the 529 plans assets. They find out, however, that 529 funds should only be used1 for qualified education expenses, which excludes private school costs.

While Barbara and Sam have accomplished their goal of helping fund their grandchild's college expenses, they missed an opportunity to use a second valuable estate-planning tool and unnecessarily limited their financial flexibility. An alternative strategy without using 529 plans would enable Barbara and Sam to:

- Help pay for college.
- Make separate use of the annual gift-tax exclusion.
- Maximize their financial ability to help their grandchildren in additional situations if so desired.

Starting with the same scenario as above, Barbara and Sam instead choose the following strategies:

1) Set up and fund a regular brokerage account in their name (or even separate ones for each grandchild), which can be thought of as "designated education funding accounts."

2) When the grandchildren reach college age, Barbara and Sam pay the tuition directly by writing a check to the institution's bursar. Estate tax rules allow for an ***unlimited amount*** to be paid directly for college tuition without triggering gift taxes.

3) Make annual tax-free gifts to their children and/or grandchildren for them to use as they see fit, such as to help pay for private school tuition.

In this scenario, the flexibility offered by the alternative strategies trumps the potential tax advantages of 529 plans. The underlying theme is that considering how the individual financial pieces fit together is the key to a successful plan. College funding strategies, taxes, estate planning and portfolio management can be seen as interconnected components of a wealth management strategy. By viewing all the components together along with a families' goals and constraints, the best solutions can be crafted.

The earnings portion of 529 plan assets distributed for non-qualified expenses are subject to a 10% penalty in addition to ordinary income tax.

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