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Funding a Grandchild's College Education

This article examines a number of college-funding mechanisms available to grandparents for their grandchildren. In light of the multifaceted considerations and often conflicting factors, it shows which approaches are most appropriate in any given set of circumstances.

By Richard L. Kaplan

As Americans live longer, the prospect of seeing a grandson or granddaughter attend college is an increasingly common phenomenon. With the high cost of college education hitting many parents when they are trying to fund their approaching retirement, many grandparents are choosing to help finance their grandchildren's college expenses. There are several ways of doing so, with very different consequences for the parties involved, and that is the focus of this article.

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To determine the approach that best serves all family members, this article begins by considering several factors that are relevant to the financing of a grandchild's college expenses. These factors include the grandparents' and the grandchild's income tax situations, the grandparents' possible exposure to gift and estate taxes, and their desire to ensure that the funds they provide are actually used to pay for college costs. This article also considers the Medicaid implications for the grandparents and the impact on a grandchild's eligibility for need-based financial aid. The article then examines various mechanisms that are available to fund a grandchild's college costs and analyzes each mechanism in terms of the factors just described to determine which mechanism is most suitable in which circumstances.

Income Taxation

Grandparents often find themselves in higher income tax brackets than their grandchildren,¹ so shifting the locus of taxation from the grandparents to the grandchildren can lower the income tax burden on funds that are intended for college costs.² If the interest income and dividends earned on those funds are taxed at the grandchild's lower income tax rate, they can accumulate faster. For example, assume that grandfather Alan transfers \$10,000 to his granddaughter, Stephanie, who invests these funds in government securities. The interest earned on these bonds (say, \$600) will be taxed at Stephanie's tax rate, which is probably 15 percent, and the tax due would be \$90 (\$600 x 15%). In contrast, Alan's tax bracket is probably 28 percent to 39.6 percent, resulting in a tax liability of \$168 to \$238, depending upon his specific situation. If Stephanie's income is within her standard deduction of \$750 (in calendar year 2001),³ her income tax on this interest income is zero.⁴ The point is that the income tax on Alan

can be reduced substantially if his granddaughter reports the income instead of him.

Capital Gains

A similar benefit is possible if a grandparent transfers a capital asset that has gone up in value, such as stock or mutual fund shares. In that case, the grandparent's "basis" in the asset carries over to the grandchild,⁵ and no capital gains tax is due until the grandchild sells the asset. When that happens, the grandchild pays tax on the gain realized, including the gain that accrued while the grandparent owned the asset. For example, assume that grandmother Rachel bought a stock three years ago at \$2,000 that is now worth \$9,000. When she transfers this stock to her grandson Samuel, Rachel's basis—\$2,000—becomes his "cost" for tax purposes.⁶ And, if Samuel then sells this stock for, say, \$9,300, he reports a gain of \$7,300 (sale price of \$9,300 – basis of \$2,000).

Moreover, when Samuel reports this gain, the applicable tax rate will probably be 10 percent, the capital gains tax rate that applies to gains within the 15 percent income tax bracket.⁷ Since the 15 percent bracket covers taxable income of up to \$27,050 (in 2001)⁸ for unmarried filers, most grandchildren are eligible for this 10 percent rate. In contrast, many grandparents would pay tax at the 20 percent capital gains rate that applies to gains that exceed the 15 percent income tax bracket.⁹ Thus, the tax burden on capital assets can be reduced by half if a grandparent transfers an appreciated asset to the grandchild, instead of selling the asset first and then transferring the proceeds of that sale.

Special Five-Year Rule

An additional tax savings possibility went into effect on January 1, 2001, for capital assets held at least *five* years,¹⁰ rather than the customary one year required for capital gain treatment.¹¹ Under this provision, the 10 percent tax rate referred to above is reduced to 8 percent.¹² Thus, the transfer of an asset held long-term can reduce the applicable tax rate from 20 percent for most grandparents to 8 percent in the hands of their grandchildren.

Furthermore, it is not necessary that the grandchild hold the asset for the required five years. Under general tax principles, the holding period of a donor carries over to the donee.¹³ So, as long as the *combined* holding periods of the grandparent and the grandchild equal five years, the requirement is met.

As a result, this special 8 percent tax rate can apply immediately to a capital asset owned by a grandparent since January 1, 1996, regardless of when the grandchild receives it.

"Kiddie Tax" Caveat

A major caveat applies, however, if a grandchild is not yet 14 years of age. The "unearned income" of anyone under age 14 is taxed at the marginal rate that applies to that person's parents¹⁴—in most cases eliminating the tax benefits of the income-shifting strategy described above. This so-called kiddie tax applies to interest income, dividends, and capital gains¹⁵ when the sum of such income exceeds \$1,500 (in 2001).¹⁶ Thus, transferring assets to reduce the income tax burden on those assets works best if the grandchild in question is at least 14 years old by the end of the taxable year.¹⁷

Gift and Estate Taxation

Federal gift and estate taxes provide generous exclusions that protect most college-oriented transfers from liability. No gift tax applies to the first \$10,000 given per year by a grandparent to a grandchild.¹⁸ Moreover, if the grandmother and grandfather treat the transfer as a joint gift,¹⁹ this annual exclusion effectively doubles to \$20,000.²⁰ Thus, grandmother Peg and grandfather Dean can give their granddaughter Alana \$20,000 *per year*, with no gift tax liability whatsoever. Additionally, if the gift exceeds this parameter, only the excess is treated as a taxable gift.

Lifetime Exemption

Even when part of a gift is treated as taxable, no gift tax is owed until the cumulative total of these taxable gifts exceeds a donor's estate tax exemption.²¹ So, if Peg gave Alana stock worth \$13,000 at the date of the gift, \$10,000 is excluded by the annual allowance, and the remaining \$3,000 is applied against Peg's lifetime estate tax exemption. This exemption is \$675,000 per person in 2001²² and is scheduled to rise to \$700,000 in 2002, and to \$1,000,000 by 2006.²³ Thus, most college-oriented gifts should bear no gift tax.

Education Cost Exclusion

An additional gift tax exclusion applies specifically to education expenses. Under this provision, any payment of college tuition costs that is made directly to an educational institution is exempted from gift

tax.²⁴ This provision has no upper limit, does not affect the \$10,000 annual exclusion, and does not require a joint gift election.²⁵ So, if grandmother Deborah pays \$32,000 directly to Amherst College for grandson Andrew's tuition, there is *no* gift tax due, and she can still send Andrew \$10,000 per year to cover other expenses, or for whatever purpose she deems appropriate.

Control Over the Funds

When a grandparent gives money or property to a grandchild who is a minor, those assets are typically placed in a custodial account. The effect of this arrangement is that the grandchild cannot access these funds for any purpose, educational or otherwise. Only the custodian can decide when and how to use the funds in the account.²⁶ But when the account terminates under state law, the grandchild has unfettered access to the assets in the account.²⁷ Those assets may then be used to pay college bills or not—that is the grandchild's choice.

In most states, a custodial account can continue until a grandchild is 21 years old,²⁸ by which time, most of the grandchild's college costs have probably been paid. Some states, however, terminate these accounts when the beneficiary becomes 18 years of age.²⁹ In that situation, the grandchild has access to the funds well before most college costs are incurred and might use the account for purposes other than those that the grandparent had intended. Even then, of course, a grandparent can manifest his or her displeasure by curtailing future gifts or by revising an anticipated bequest. In any case, the significance of this factor clearly depends on the applicable state law and the maturity of the specific grandchild in question.

Medicaid Implications

Like most older Americans, grandparents are increasingly confronting the cost of long-term care for themselves. Average expenses for such care exceed \$50,000 per year,³⁰ a figure that easily outstrips the ability of many grandparents to finance this cost without seriously depleting, or even exhausting, their entire net worth. At the same time, less than 10 percent of older Americans own private long-term care insurance³¹ that would cover the expenses of nursing homes, assisted living, and similar arrangements. For such people, reliance on government programs is likely.

In this context, however, the federal government's health care program for older Americans, Medicare, is wholly inadequate. Medicare provides coverage only for "skilled nursing care" and then for a maximum period of 100 days.³² After that, its coverage ceases. And if a grandparent does not need "skilled nursing care," but requires only some assistance with the ordinary tasks of daily living (such as eating, toileting, etc.),³³ Medicare provides no coverage at all.³⁴ When such so-called custodial care is required, a grandparent must turn to Medicaid, a joint federal and state health care program that covers some long-term care costs, particularly nursing home expenses.³⁵

Medicaid, however, is a poverty program that is restricted to persons of very limited means. Any grandparent who has assets beyond a residence and a prepaid burial plan must "spend down" those assets until the Medicaid eligibility criteria are met.³⁶ Accordingly, even if a grandparent is not presently poor enough for Medicaid, the implications of certain financial arrangements on that person's future Medicaid eligibility are very important.

Asset Transfers

In the specific context of college funding, a grandparent might be concerned about the Medicaid implications of transferring assets to a grandchild. These transfers leave the grandparent with fewer assets, enabling the grandparent to more readily meet Medicaid's resource eligibility requirements. But federal law discourages such asset transfers by imposing a "transfer penalty" for any transfer made during the 36 months before a person applies for Medicaid benefits.³⁷ Thus, a transfer of assets by a grandparent to a grandchild might subject the grandparent to a transfer penalty.

Medicaid's transfer penalty is calculated by dividing the amount of the asset transfer by the average monthly nursing home cost for the applicant's state or county of residence.³⁸ The resulting figure is the number of months from the date of the asset transfer during which Medicaid benefits are denied. For example, if grandfather Will transfers \$30,000 to his grandson, Ellis, and the average cost of a nursing home in the county where Will resides is \$3,000 per month, the penalty period is ten months (\$30,000 / \$3,000 per month). As a result, Will is ineligible for Medicaid benefits for ten months from the date of his gift to Ellis.

Look-Back Period

This penalty is imposed, however, only on transfers made within 36 months of applying for Medicaid.³⁹ So, if Will transferred the \$30,000 to his grandson and then waited three years before applying for Medicaid, no penalty period would apply. Incidentally, the look-back period for transfers made to a trust is 60 months, rather than 36 months.⁴⁰ In either case, transfers made within the look-back period render an applicant ineligible for Medicaid benefits, but transfers that occur before that period do not.

These transfer rules apply only to “uncompensated” transfers of assets.⁴¹ Therefore, if Will purchases something of value, the transaction is not an “uncompensated” transfer, and the Medicaid transfer penalty provisions do not apply.

Financial Aid Ramifications

A significant portion of the financial aid that is provided by colleges and universities is awarded on the basis of academic achievement or some other criterion of individual merit. But an even larger portion is awarded according to an institution's assessment of a particular student's financial “need.” This type of financial aid is strongly impacted by a student's assets and resources, since a student's “need” is determined after calculating that person's “expected family contribution,” or EFC.⁴²

Calculating the EFC

In determining the EFC, a student is expected to “contribute” 35 percent of his or her assets, including any retirement accounts that the student might have established.⁴³ Thus, a grandparent who transfers assets to a grandchild might reduce that grandchild's prospects of receiving need-based financial aid. In this context, the grandchild would be better served by having the grandparent retain the assets in question, since a grandparent's resources are generally ignored in calculating the EFC.⁴⁴

Other aspects of the EFC calculation methodology, however, might make the receipt of financial aid unlikely regardless of what a grandparent does. For example, a student's parents are expected to supply 22 percent to 47 percent of the family's after-tax income, depending on the amount of that income.⁴⁵ And the 47 percent figure applies to income over \$23,000 (in 2001–02), after excluding an “income protection allowance.”⁴⁶ This allowance is based on the number of people in the family and the number of students in

college at one time, but generally ranges from \$10,580 to \$27,090 (in 2001–02).⁴⁷ In addition, the student's parents are expected to contribute a portion of their nonretirement assets, which often includes the equity in their principal residence.⁴⁸ As a consequence of these rules, many grandchildren will receive very little need-based financial aid, so grandparents can transfer assets to these grandchildren without affecting the grandchildren's financial aid packages.

College Funding Mechanisms

In recent years, several mechanisms have been developed to fund college costs, either through the federal tax code or by various state enactments. These mechanisms include college savings bonds (both state and federal), prepaid tuition plans, college savings plans, and education IRAs. Each of these mechanisms will now be analyzed, beginning with the timeless approach of outright gifts, according to the factors set forth in this article.

Gifts

Outright gifts are unrestricted transfers of assets from a grandparent to his or her grandchild. Such transfers may occur just before college bills come due or many years before that time.

Income Taxation

Gifts of money or property to a grandchild can significantly reduce the income tax on investment earnings that are derived from such gifts. As noted earlier, the amount of the tax savings depends upon the relative tax brackets of the grandparent and the grandchild, and how long the particular asset has been held, if it is a capital asset. These tax savings are limited to the first \$1,500 (in 2001) of interest income, dividends, and capital gains,⁴⁹ unless the grandchild is at least 14 years old. If that is the case, the “kiddie tax” does not apply, and the income tax savings can be several thousands of dollars per year.⁵⁰

Gift Taxation

In most circumstances, there will be no gift tax on transfers of assets between grandparents and their grandchildren. The annual exclusion of \$10,000 can effectively be doubled via the joint gift election, even if the funds come exclusively from one grandparent. Also, if this exclusion does not shelter the entire gift, the lifetime estate tax exemption (currently \$675,000, soon to increase)⁵¹ should shield most

education-oriented transfers from any gift or estate taxation. Furthermore, direct payments of college tuition charges are exempt from gift tax, regardless of their amount.

Control of Funds

Gifts to minor grandchildren are restricted via standard custodial arrangements until those arrangements terminate.⁵² Depending upon the applicable state law, a grandchild may not have unfettered access to the funds until the senior year of college. Thus, the risk of unintended use of the grandparents' funds may be quite limited.

Medicaid Implications

Outright gifts are "uncompensated transfers" under Medicaid law and will generate an ineligibility period to the grandparent. However, gifts that occur before the 36-month look-back period (60 months for transfers to a trust) have no adverse impact on a grandparent's possible eligibility for Medicaid benefits.⁵³

Financial Aid Impact

Financial aid considerations dictate that funds not be transferred to a grandchild until after financial aid awards have been determined. If a grandparent does not want to defer the gift that long, transferring assets to the grandchild's parents instead of to the grandchild will minimize the impact of those transfers on the amount of need-based financial aid that the grandchild will receive.⁵⁴ In any case, if the income of the grandchild's parents is sufficiently high that financial aid will probably not be awarded, this consideration is basically irrelevant.

College Savings Bonds

Many states issue special debt obligations marketed as college savings bonds. Actually, these bonds can be used for any purpose—not just college costs—and they can be purchased by anyone. College savings bonds do have some features, however, that make them especially appropriate for college savings. For example, these bonds are typically noncallable; that is, they cannot be redeemed by the issuing state prior to their stated maturity date. Thus, a grandparent purchasing such a bond can be assured that a grandchild will receive the full maturity value of the bond, regardless of what happens to prevailing interest rates until then. In addition, state-issued college savings

bonds often mature during the month of August, further facilitating their usefulness in meeting college expenses.

Income Taxation

Interest on state-issued college savings bonds is exempt from federal income tax.⁵⁵ In this regard, it does not matter whether a grandparent owns the college savings bonds directly or if the bond is registered in the grandchild's name. The interest income is tax-exempt in either case. Such interest may also be exempt from state income tax if the bonds were issued by the state that is imposing the tax.

Gift Taxation

Gifts of bonds are generally treated like gifts of other property for gift tax purposes, but college savings bonds have one feature that further reduces their gift tax exposure. Most college savings bonds are issued on a zero-coupon basis; that is, these bonds pay no interest currently, and they are purchased at a substantial discount to their eventual maturity value. Thus, a bond that will pay \$1,000 when it matures in 18 years may be purchased for only \$289.83.⁵⁶ Since gift tax is imposed on an asset's value at the time of its gift,⁵⁷ the relevant figure is the *cost* of the bond and not its eventual maturity value. As a result, the annual gift tax exclusion will shield most gifts of college savings bonds from any gift tax—even for fairly significant bond purchases.⁵⁸

Control of Funds

College savings bonds are not restricted in any significant way for college expenses, and when these bonds mature, their value can be applied to any purpose, educational or otherwise. Therefore, a grandparent who wants to maintain control over how the investment is used should purchase the bonds in his or her name, rather than in the grandchild's name.

Medicaid Implications

Medicaid eligibility considers all of an applicant's assets, other than certain "noncountable" assets, and college savings bonds do not fall into that category.⁵⁹ So, if a grandparent registers a college savings bond in his or her own name, that bond will affect the grandparent's eligibility for Medicaid benefits. Any transfer of the bond, moreover, would be an

“uncompensated transfer.” If this transfer occurs within the applicable look-back period, the grandparent will be subject to an ineligibility period.⁶⁰ Registering the bond in a grandchild's name initially would be treated the same as transferring the bond.

Financial Aid Impact

Like most other assets, college savings bonds that are titled in a grandchild's name are treated as assets of the grandchild. Accordingly, they are counted heavily in determining the “expected family contribution.” Their impact will be much less if the bonds are registered in the name of the grandchild's parents, and the bonds will usually be ignored if they are titled in the grandparent's name.⁶¹

Federal Savings Bonds

The preceding analysis dealt with state-issued college savings bonds, but it applies with equal force to many federally issued savings bonds. Although interest earned on U.S. savings bonds is generally taxable, it may be exempt from federal income tax if the proceeds of the bonds are used to pay college tuition expenses.⁶² This provision does not, however, apply to other college expenses, such as room and board.⁶³

To qualify for this exemption, the bonds must have been issued after 1989, and the bonds' purchaser must have been at least 24 years old when the bonds were purchased.⁶⁴ As a result, this exemption cannot apply to bonds purchased in a grandchild's name, except in very unusual circumstances. And, if a grandparent purchases the bonds in his or her own name, the tax exemption will usually not apply because the tuition expenses in question must be those of a “dependent.”⁶⁵ A grandchild is not a dependent of the grandparent, unless the grandparent provides more than half of the grandchild's support in the year the bonds are redeemed.⁶⁶

A grandparent could, however, purchase these bonds in the name of the grandchild's parent. This approach should resolve the dependency issue in most situations, but sets up a different dilemma if a parent's adjusted gross income (AGI)⁶⁷ is too high.⁶⁸ The tax exemption is phased out ratably for joint return filers with AGI between \$83,650 and \$113,650 (in 2001), and for unmarried filers with AGI between \$55,750 and \$70,750 (in 2001).⁶⁹ Parents whose AGI exceeds the upper limit of these ranges get no tax exemption at all. In this context, the relevant

AGI is for the year in which the bonds are redeemed⁷⁰—*not* the year in which the bonds were purchased. Consequently, qualifying for the tax exemption might be highly problematic, since it depends upon the future economic circumstances of the parent-bondholder.

Prepaid Tuition Plans

Thirty-three states offer prepaid college tuition plans that cover tuition charges at any public institution of higher education in the state.⁷¹ These plans provide that the beneficiary, who is designated in the contract, is entitled to however many years of college tuition the contract covers, regardless of what that tuition eventually costs. In effect, these contracts insulate the beneficiary from future tuition increases.⁷² Generally, any state resident can purchase a prepaid tuition contract, and out-of-state grandparents can often purchase a contract for a grandchild, if that grandchild is a resident of the state in question. These plans vary in their refund provisions, how they apply to private institutions, and how they apply to out-of-state colleges and universities.⁷³ The best financial result is obtained when the plan is used at a public institution in the state that issued it.

Income Taxation

Taxable gain from these plans results from the difference between the cost of the contract and the actual value of the tuition when the benefits are claimed.⁷⁴ This gain is not recognized for tax purposes, however, until the student enrolls in college—a possibly significant deferral of tax liability. Moreover, when the gain is taxed, it is taxed to the student who claims the contract's benefits, rather than to the person who purchased the contract.⁷⁵ Thus, if a grandparent purchases a prepaid tuition contract, the “profit” component will be taxed at the grandchild's applicable tax rate, which is usually lower than the grandparent's tax rate, in many cases substantially lower. And since almost no grandchildren attend college before they are 14 years old, the “kiddie tax” does not apply to these profits.⁷⁶ Thus, prepaid tuition plans permit intergenerational tax shifting, as well as deferral of income tax liability.

Gift Taxation

Most prepaid tuition plans are limited to four years of in-state tuition and, therefore, cost less than

\$20,000.⁷⁷ Accordingly, grandparents can usually buy a prepaid tuition plan without exhausting their annual gift tax exclusion. In any case, a special tax rule allows the purchaser of such a contract to treat the purchase as taking place ratably over five years.⁷⁸ Thus, even if a grandparent no longer has a spouse with whom to make a joint gift election, that grandparent can expend up to \$50,000 for a prepaid tuition plan without incurring any gift tax liability⁷⁹ and without utilizing his or her lifetime estate tax exemption. Another implication of this five-year rule is that a grandparent who purchases a prepaid tuition contract can make additional gifts without exceeding the \$10,000 annual exclusion. For example, if grandmother Leah buys a \$15,000 prepaid tuition plan for her grandson, David, she may treat the \$15,000 contract price as a series of five annual gifts of \$3,000 each, thereby enabling her to give David additional gifts of as much as \$7,000 per year.⁸⁰ Leah can then do likewise with her three other grandchildren—all without exceeding the annual gift tax exclusion.

Control of Funds

Unlike an unrestricted gift or bequest, a prepaid tuition contract can be used for only one thing: paying the costs of a college education. The particulars of state plans vary considerably, but most plans have fairly limited provisions for refunds.⁸¹ Thus, a grandchild who decides not to attend college cannot “cash in” the contract and use the proceeds to buy a car, for example. And only the grandparent as contract owner can change the plan’s beneficiary to some other family member.⁸² In so doing, the grandparent ensures that the funds represented by the prepaid tuition plan will be used as intended—even if not by the originally designated grandchild.

Medicaid Implications

The Medicaid implications of a prepaid tuition plan are less than clear. If the contract is considered a purchase for value, it is not an “uncompensated transfer,” and no period of Medicaid ineligibility should apply to the grandparent who purchases the plan.⁸³ In that case, however, the prepaid tuition plan would be an asset of the grandparent and is counted against that person’s Medicaid resource limit.⁸⁴ Determining the value of such a plan, however, inevitably involves an examination of the specific contract’s refund provisions and conditions.

If the plan cannot be cashed in, it might be treated as a *de facto* gift to the grandchild who is named as the contract’s beneficiary. In that circumstance, the transfer penalty rules will apply. Thus, although the question is not free from doubt, a grandparent’s purchase of a prepaid tuition plan probably affects that person’s Medicaid eligibility—either as a countable asset or as a potentially penalizable transfer of assets.

Financial Aid Impact

Prepaid tuition plans extinguish a student’s liability for tuition charges completely. Accordingly, these plans are treated as dollar-for-dollar offsets against a student’s “need.”⁸⁵ In other words, these plans are treated more harshly than a grandchild’s other assets, since only 35 percent of those assets are counted in the “expected family contribution,”⁸⁶ not 100 percent. In any case, there are many costs of attending college beyond tuition charges. Although federal law allows states to offer prepaid plans for college expenses other than tuition,⁸⁷ none of the plans that are currently available do so. Thus, prepaid tuition plans may offset a grandchild’s tuition costs, but they do not affect a grandchild’s eligibility for financial aid for the other components of the college expense package.

College Savings Plans

Recently, some states have created college savings plans to counter three of the limitations presented by the prepaid tuition programs analyzed above. First, these college savings plans are not limited to tuition expenses, but can be used for any cost of attending college.⁸⁸ Second, the new plans may be used at any accredited college or university, public or private, in-state or out-of-state. Third, there is usually no residency requirement for contract purchasers,⁸⁹ so grandparents can invest in these plans without regard to where they live.

On the other hand, these plans provide no guarantees about future costs, unlike prepaid tuition plans. The “sponsoring” state makes no representation that the assets in the plan will be sufficient to pay any college expenses. In fact, the plan’s assets may actually *decline* in value. These assets, after all, consist of mutual funds that are operated by the plan’s administrator, usually an established securities firm with no special connection to the state that “sponsors” the college savings plan.⁹⁰

Income Taxation

College savings plans are taxed like prepaid tuition plans,⁹¹ except that there is no guarantee of profit. Whatever appreciation is realized within the plan is taxed at the grandchild's tax rate when the funds are used to pay college expenses. Thus, the grandparent is able to shift the tax on the plan's investment gains, if any, to the (presumably) lower tax bracket grandchild and to defer the recognition of those gains until they are withdrawn from the plan.

Gift Taxation

As with prepaid tuition plans, a grandparent can elect to treat an investment in a college savings plan as a series of five annual gifts.⁹² In so doing, a grandparent can shelter up to \$50,000 per donee from gift tax. This provision has particular significance for college savings plans because these plans are not limited to tuition costs and are not based on in-state charges. As a result, much larger amounts can be invested in a college savings plan than in a prepaid tuition plan. Upper limits may exceed \$150,000 per beneficiary, depending upon the particulars of a given plan.⁹³ Two grandparents electing joint gift treatment would thus be able to shield an investment of \$100,000 from gift taxes⁹⁴ and could then apply any further investment against their lifetime estate tax exemption. Any additional gifts within five years of this investment, however, would be offset against the grandparents' estate tax exemption and may even incur gift tax liability.

Control of Funds

Once funds are invested in a college savings plan, the purchasing grandparent cannot determine how those funds are invested.⁹⁵ That is solely the responsibility of the plan administrator. Be that as it may, the grandchild beneficiary cannot access the plan's assets other than to pay college expenses and cannot even pledge the plan's assets as security for a loan.⁹⁶ The grandparent can, however, change the plan's beneficiary to anyone related to the current beneficiary,⁹⁷ including that person's spouse, children, step-siblings, or in-laws.⁹⁸

Medicaid Implications

A college savings plan is essentially a tax-deferred investment program that is established to cover a grandchild's college expenses. The grandparent-owner of the plan has no control over the plan, other

than an ability to change the plan's beneficiary. Since the plan provides no guarantees about future growth, it is not a purchase for value. Instead, a college savings plan is probably best classified as an indirect gift to the grandchild who is designated as the plan's beneficiary. Accordingly, the transfer penalty rules apply to such investments, and a grandparent should wait 36 months after contributing to a college savings plan before applying for Medicaid benefits.⁹⁹

Financial Aid Impact

These plans have not been definitively classified for financial aid purposes, but they are probably best treated as assets of the grandchild-beneficiary. These plans do not extinguish any specific college cost, unlike prepaid tuition plans, so they should not offset a grandchild's "need" dollar-for-dollar.

Education IRA

In 1998, yet another tax-favored device for funding college costs became available, the Education IRA. Under its provisions, a grandparent can contribute up to \$500 per year per grandchild to a special account that is administered by some of the same financial institutions that administer retirement-oriented savings vehicles.¹⁰⁰ The grandchild must be under age 18 when the account is funded,¹⁰¹ so the Education IRA is most suitable for younger grandchildren who can receive perhaps as many as 18 annual contributions. The \$500 limit, however, is per beneficiary,¹⁰² so if grandmother Pearl contributes \$500 to an Education IRA for her grandson, Max, no one else may fund an Education IRA for Max that year.¹⁰³

Funding Restrictions

Several other funding restrictions apply as well. If an Education IRA is funded, a prepaid tuition plan or college savings plan cannot be purchased for the same beneficiary that year.¹⁰⁴ Thus, grandparents must coordinate their investments with other family members to avoid violating this rule. And, since those other plans can involve much larger sums,¹⁰⁵ it is imperative that no one fund a \$500 Education IRA when a prepaid tuition plan or a college savings plan is being considered.

In addition, funders of Education IRAs may not have adjusted gross incomes over \$110,000 if they are unmarried, or \$160,000 if they file joint tax returns.¹⁰⁶ Most grandparents fall within these

parameters, and those who do not can still fund an Education IRA for their grandchildren via gifts. Education IRAs do not require earned income, so a grandparent can give \$500 to his grandchild, who is (presumably) eligible to fund the Education IRA directly.¹⁰⁷

Income Taxation

No tax is imposed while funds accumulate within an Education IRA,¹⁰⁸ and no tax is imposed on withdrawals if they do not exceed the college costs that the beneficiary incurred that year.¹⁰⁹ For this purpose, college costs include tuition, room and board charges, and required fees.¹¹⁰ Accordingly, this requirement should pose no problem for most grandchildren, especially since the maximum contribution to an Education IRA is only \$500 per year.

Gift Taxation

Contributions to an Education IRA are eligible for the \$10,000 annual gift tax exclusion,¹¹¹ so there should be no gift tax consequences from funding these accounts. If a grandparent has already used the \$10,000 annual exclusion for a specific grandchild that year, simple intra-family coordination should enable someone other than the grandparent to fund the Education IRA. The grandparent's lifetime estate tax exemption remains available, of course, if this coordination does not take place.

Control of Funds

Education IRAs are intended to fund college expenses, and it is only in that context that withdrawals from these accounts are tax-free. Withdrawals for any other purpose are fully taxable and subject to a 10 percent penalty in addition.¹¹² Moreover, any funds that have not been distributed from an Education IRA by a grandchild's thirtieth birthday are deemed to be distributed—and taxed—at that time.¹¹³ Thus, an Education IRA makes economic sense only if it is used for college expenses. In any case, a grandchild who has not used the funds before turning age 30 can roll over any unused funds, tax-free, to an Education IRA for any member of the grandchild's family, broadly defined, who has not yet reached age 30.¹¹⁴ Alternatively, a grandparent could change the beneficiary of the Education IRA to anyone who would qualify for a tax-free rollover; that is, any relative of the grandchild-beneficiary who is under age 30.¹¹⁵

Medicaid Implications

Education IRAs are simply dedicated savings accounts. They offer no guarantees and may even decline in value, depending upon the performance of the specific investments in those accounts. Accordingly, funding an Education IRA is probably a transfer of assets for Medicaid purposes, rather than a purchase for value.

In most cases, however, no transfer penalty will be imposed. The penalty formula divides the amount of an uncompensated transfer by the average cost of a nursing home in the grandparent's county or state.¹¹⁶ Since nursing homes cost more than \$500 per month (the maximum annual contribution to an Education IRA), the resulting period of ineligibility for Medicaid benefits would be less than one month.¹¹⁷ Consequently, funding a grandchild's Education IRA should not affect the grandparent's application for Medicaid assistance.

Financial Aid Impact

An Education IRA is an asset of the grandchild-beneficiary for financial aid purposes, like any other resource of a student who is applying for such aid.

Conclusion

When grandparents consider financing their grandchildren's college education, a variety of legal and practical factors come into play. These factors include the relative income tax brackets of the people involved, the grandparents' estate tax situation, the age and maturity of the grandchildren, and the desire by the grandparents to ensure that their funds are used as they intended. Other factors include possible implications for the grandparents' need for Medicaid assistance with their long-term care expenses, and the impact of the grandparents' benevolence on the grandchildren's eligibility for need-based financial aid. As is true with so many aspects of personal financial planning, the proliferation of alternatives has made the process ever more challenging for elder advisors and their clients.

Impact of New Tax Act

After this article went to press, Congress passed the Economic Growth and Tax Relief Act of 2001. This Act makes several changes that are relevant to inter-generational tax planning, including a lowering of income tax rates by one percent effective July 1, 2001. This rate reduction does not apply,

however, to the 15 percent income tax rate that affects almost all grandchildren. A new 10 percent rate will apply starting January 1, 2002 to the first \$6,000 of taxable income for single taxpayers who are claimed as someone else's dependents, a category that includes most grandchildren. With respect to gift and estate taxes, the Act raises the lifetime exemption to \$1,000,000 effective in 2002.

In addition, the new Act contains several provisions pertaining specifically to educational costs planning, all effective starting in 2002. Gains realized on most prepaid tuition plans will be tax-exempt, rather than merely tax-deferred as long as they are used to pay higher education expenses. Moreover, the annual contribution limit for Education IRAs is increased from \$500 to \$2,000, also starting in 2002.

Endnotes

1. The income tax brackets are contained in I.R.C. § 1(a)-(d), and the dollar parameters are indexed for inflation. I.R.C. § 1(f). These parameters for calendar year 2001 are set forth in Rev. Proc. 2001-13, § 3.01, 2001-3 I.R.B. 337.
2. To shift the locus of investment income taxation, a taxpayer must transfer the assets that generate the investment income. See *Blair v. Commissioner*, 300 U.S. 5, 12 (1937).
3. I.R.C. § 63(c)(5)(A), as adjusted for inflation by Rev. Proc. 2001-13, § 3.05(2), 2001-3 I.R.B. 337.
4. See I.R.C. §§ 63(a), (b)(1).
5. See I.R.C. § 1015(a).
6. If an asset's fair market value when it is transferred to the grandchild is less than the grandparent's basis in that asset, determining the grandchild's basis in the asset is more complicated. See I.R.C. § 1015(a).
7. I.R.C. § 1(h)(1)(B).
8. I.R.C. § 1(c), as adjusted for inflation by Rev. Proc. 2001-13, § 3.01 (Table 3), 2001-3 I.R.B. 337.
9. I.R.C. § 1(h)(1)(C).
10. I.R.C. §§ 1(h)(2), (9).
11. I.R.C. §§ 1(h)(1)(A)(i), 1222(3), (7), (11).
12. I.R.C. § 1(h)(2)(A).
13. I.R.C. §§ 1015(a), 1223(2).
14. I.R.C. §§ 1(g)(1)(B)(ii), (3)(A)(i), (4).
15. See I.R.C. § 1(g)(4)(A)(i).
16. I.R.C. § 1(g)(4)(A)(ii), as adjusted for inflation by Rev. Proc. 2001-13, § 3.05(2), 2001-3 I.R.B. 337.
17. See I.R.C. § 1(g)(2)(A).
18. I.R.C. § 2503(b)(1).
19. I.R.C. § 2513(a)(1).
20. RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶ 1.03[4] (6th ed. 1991). Similar exclusions apply to the "generation-skipping transfer" tax. See I.R.C. § 2642(c)(1), (3)(A).
21. I.R.C. §§ 2010(c), 2505(a).
22. I.R.C. § 2010(c).
23. *Id.*
24. I.R.C. §§ 2503(e)(1), (2)(A). Such gifts are also excluded from the "generation-skipping transfer" tax. See I.R.C. § 2611(b)(1).
25. Treas. Reg. §§ 25.2503-6(a), (b)(2) (1984); see generally KATHRYN G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION* ¶ 10.02 (1998).
26. See generally Henry J. Lischer, *Gifts to Minors*, 846 TAX MGMT. PORTFOLIO A-16(2) to A-18 (1997).
27. See 1 RICHARD A. WESTIN, *FEDERAL TAX PLANNING* § 3.36, at 3-36 (2d ed. 1995).
28. See Stephanie Gallagher, *The Case for Saving in a Child's Name*, KIPLINGER'S PERS. FIN. MAG., Oct. 1998, at 51, 52 (only seven states and the District of Columbia require that custodial accounts terminate when the beneficiary reaches age eighteen); Lischer, *supra* note 26, at A-18.
29. Gallagher, *supra* note 28; WESTIN, *supra* note 27.
30. See John Greenwald, *Elder Care: Making the Right Choice*, TIME, Aug. 30, 1999, at 52, 55.
31. Joshua M. Wiener et al., *Federal and State Initiatives to Jump Start the Market for Private Long-Term Care Insurance*, 8 ELDER L.J. 57, 60 (2000).

32. LAWRENCE A. FROLIK & RICHARD L. KAPLAN, *ELDER LAW IN A NUTSHELL* 69–70 (2d ed. 1999). After the twentieth day, there is a deductible of \$99 per day (in 2001). See *Medicare Premium Amounts for 2001*, <http://www.medicare.gov/basics/amounts2001.asp> (visited Jan. 30, 2001).
33. See FROLIK & KAPLAN, *supra* note 32, at 69 (providing examples of “skilled nursing care”).
34. Private “medigap” insurance does not extend beyond Medicare’s coverage of “skilled nursing care,” although it can cover the per-day deductible for days 21 through 100. See *id.* at 93, 95.
35. See generally *id.* at 101–04.
36. *Id.* at 109–10, 114. The general resource limit for an unmarried Medicaid applicant is \$2,000; married applicants have higher limits, with the specific amount depending upon the state of the applicant’s residence.
37. *Id.* at 122.
38. *Id.*
39. *Id.*
40. *Id.* at 125.
41. *Id.* at 123.
42. See generally *The EFC Formula, 2001-2002*, http://ifap.ed.gov/efcinformation/attachments/Tables_EFC_0301.pdf (visited May 10, 2001); Mark Kantrowitz, *FinAid Page*, <http://www.finaid.org/calculators/finaidestimate.phtml> (visited Jan. 30, 2001).
43. See *supra* note 42; see also Kristin Davis, *College Aid: The Nitty-Gritty Guide*, *KIPLINGER’S PERS. FIN. MAG.*, Jan. 1998, at 95, 98.
44. A grandparent’s resources are considered in determining the EFC, if the grandparent is the legal guardian of the student who is applying for financial assistance. See *The EFC Formula*, *supra* note 42.
45. See *The EFC Formula*, *supra* note 42, at Table A6; Davis, *supra* note 43, at 96.
46. See *The EFC Formula*, *supra* note 42, at Table A6.
47. See *id.* at Table A3.
48. See *The EFC Formula*, *supra* note 42; Davis, *supra* note 43, at 97.
49. See I.R.C. §§ 1(g)(4)(A)(i), (ii).
50. For example, if a grandchild’s investments produce taxable income of \$20,000 per year, her income tax would be \$3,000 in the 15 percent tax bracket, while the same income received by her grandparent in the 36 percent bracket would generate a tax liability of \$7,200—a differential of \$4,200 per year. Additional tax savings might be available in those states with an income tax that has more than one tax rate.
51. I.R.C. § 2010(c).
52. See Lischer, *supra* note 26.
53. See FROLIK & KAPLAN, *supra* note 32, at 122, 125.
54. The EFC includes 35 percent of a student’s assets, but only 5.6 percent of the assets of the student’s parents. See Davis, *supra* note 43, at 97–98.
55. I.R.C. §§ 103(a), (c)(1).
56. \$1,000 x .28983, the present value of \$1 received after 18 years of earning 7 percent per year, compounded semiannually. See MICHAEL SHERMAN, *COMPREHENSIVE COMPOUND INTEREST TABLES* 169 (1986).
57. I.R.C. § 2512(a).
58. For example, using the numbers in the text, the annual gift tax exclusion of \$10,000 could purchase bonds with a maturity value of \$34,000, plus \$145 remaining.
59. FROLIK & KAPLAN, *supra* note 32, at 109–10.
60. *Id.* at 122.
61. See *supra* notes 44 and 54.
62. I.R.C. §§ 135(a), (c)(2).
63. See I.R.C. § 135(c)(2)(A).
64. I.R.C. §§ 135(c)(1)(A), (B).
65. I.R.C. § 135(c)(2)(A)(iii).
66. I.R.C. §§ 151(c)(1), 152(a).

67. See I.R.C. § 62(a); see generally BORIS I. BITTKER & MARTIN J. MCMAHON, JR., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 2.1[3] (2d ed. 1995).
68. See I.R.C. § 135(b)(2)(A).
69. Rev. Proc. 2001-13, § 3.08, 2001-3 I.R.B. 337. Married persons who file separate returns are ineligible for this exemption. See I.R.C. § 135(d)(3).
70. I.R.C. § 135(b)(2)(A).
71. *Prepaid Tuition Programs*, <http://www.finaid.org/othersaid/prepaid.phtml> (visited Jan. 29, 2001).
72. See Kristin Davis, *Tomorrow's Tuition at Today's Prices*, KIPLINGER'S PERS. FIN. MAG., Nov. 1995, at 101.
73. See generally June Kronholz, *Prepaid Tuition Is Catching on in More States*, WALL ST. J., Nov. 13, 1997, at B1.
74. I.R.C. § 529(c)(3)(A).
75. *Id.*
76. See I.R.C. § 1(g)(2)(A).
77. See THE COLLEGE BOARD, *TRENDS IN COLLEGE PRICING* 11 (2000) (average annual tuition and fees at four-year public institutions in 2000-01 is \$3,510, ranging from \$2,747 in the West to \$4,748 in New England).
78. I.R.C. § 529(c)(2)(B). The receipt of plan benefits does not constitute a taxable gift. I.R.C. § 529(c)(5)(A).
79. Annual gift tax exclusion of \$10,000 x 5 years = \$50,000.
80. Annual gift tax exclusion of \$10,000 - \$3,000 ratable allocation of the \$15,000 plan purchase price = \$7,000.
81. *Supra* note 71; see also I.R.C. § 529(b)(3)(A) (requiring that a plan "impose a more than de minimis penalty" for noneducational use).
82. I.R.C. §§ 529(c)(3)(C)(ii), (e)(2).
83. FROLIK & KAPLAN, *supra* note 32, at 123.
84. *Id.* at 109.
85. See *Prepaid Tuition Programs*, *supra* note 71. Some states ignore these plans in determining eligibility for state-administered financial aid. *Id.*
86. Davis, *supra* note 43, at 98.
87. See I.R.C. § 529(e)(3)(B).
88. See generally A.L. Spitzer & Christopher E. Houston, *The New QSTPs: Not Your Grandparents' State Tuition Plan*, 82 TAX NOTES 867 (1999); Stephanie Gallagher, *A Winning Way to Save for College*, KIPLINGER'S PERS. FIN. MAG., May 1998, at 50; Lynn Asinof & Karen Hube, *College-Tuition Savings Plans Aren't All Created Alike*, WALL ST. J., May 31, 2000, at C16.
89. Lynn Asinof, *States' College-Savings Plans Go National*, WALL ST. J., Sept. 23, 1999, at C1; see also *College Savings Plan Network Homepage*, <http://www.college-savings.org> (visited Jan. 31, 2001).
90. Jon Newberry, *Paving Road to College*, A.B.A.J., Feb. 2001, at 78.
91. I.R.C. § 529(b)(1)(A)(ii).
92. I.R.C. § 529(c)(2)(B). But if the grandparent dies before the end of the five years covered by this election, amounts that are allocable to the years after the grandparent's death are included in the estate of the grandparent for estate tax purposes. I.R.C. § 529(c)(4)(C).
93. See, e.g., Fidelity Investments, *Four Tips for Choosing a Plan*, <http://personal400.fidelity.com/planning/college/gparents/gparent.html> (visited Jan. 29, 2001) (describing two plans that allow \$166,600 and \$171,125 per beneficiary in 2001).
94. Annual gift tax exclusion of \$10,000 x 5 years = \$50,000 x 2 grandparents = \$100,000.
95. I.R.C. § 529(b)(5).
96. I.R.C. § 529(b)(6).
97. I.R.C. § 529(c)(3)(C).
98. I.R.C. §§ 529(e)(2)(A), (B), 152(a)(1), (3), (8).
99. See FROLIK & KAPLAN, *supra* note 32, at 122.
100. See I.R.C. §§ 530(b)(1)(A)(iii), (B).

101. I.R.C. § 530(b)(1)(A)(ii).
102. Notice 97-60, sec. 3, Q&A5, 1997-2 C.B. 310.
103. If contributions in excess of the \$500 limit are not withdrawn before the due date of the year's tax return, a penalty of 6 percent is imposed for each year that the excess contribution remains in the Education IRA. *Id.* at Q&A6.
104. *Id.* at Q&A22.
105. *See supra* note 93.
106. I.R.C. § 530(c)(1). Contributions of less than \$500 may be made by unmarried persons with AGI of \$95,000 to \$110,000, and by joint return filers with AGI of \$150,000 to \$160,000. *Id.*
107. Notice 97-60, sec. 3, Q&A10, 1997-2 C.B. 310.
108. I.R.C. § 530(a).
109. I.R.C. § 530(d)(2)(A).
110. I.R.C. §§ 530(b)(2)(A), 529(e)(3).
111. *See* I.R.C. §§ 530(d)(3), 529(c)(2)(A)(i), 2503(b).
112. *See* I.R.C. §§ 530(d)(1), (2)(A), (4)(A).
113. I.R.C. §§ 530(b)(1)(E), (d)(8).
114. *See* I.R.C. §§ 530(d)(5), 529(e)(2)(A), (B), 152(a)(1)–(8).
115. I.R.C. § 530(d)(6).
116. FROLIK & KAPLAN, *supra* note 32, at 122.
117. *See* THOMAS D. BEGLEY, JR. & JO-ANNE HERINA JEFFREYS, REPRESENTING THE ELDERLY CLIENT § 8.05[C][4] (1999). In those states that impose partial-month penalties, the penalty would be trivial: maximum Education IRA contribution of \$500, divided by the national average nursing home cost of \$4,167 = .12 month, or 4 days.