

**CASE STUDY: GRANDPARENTS USE BOTH ESTATE PLANNING AND LIFETIME GIFTS TO
ASSIST GRANDCHILDREN**

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Harry and Sally have two grown children and four grandchildren, all of whom are under age 18. Harry and Sally are close to their children, Bill and Irene. The grandchildren are a source of joy and pride. They occupy a special place in their hearts.

Harry and Sally want to include their grandchildren in their estate plans. They originally planned to simply leave everything to Bill and Irene and let them take care of the grandchildren. Then a friend told them about his grandmother's will, which included specific bequests to each of the grandchildren. That arrangement made all the grandchildren very happy, not so much because of the money involved, but because the grandmother had remembered each one of them in her will. Another friend, a lawyer, advised Harry and Sally that some grandparents set aside separate shares of their estate to be divided equally among grandchildren. For example, Harry and Sally might divide their estate into thirds, leaving one third to each of their children and the remaining third to the grandchildren, to be divided equally among them. Since the grandchildren are minors, their share of the estate might be placed in a "grandchildren's trust." Funds in this trust could be used for each grandchild's education or to assist each of them in buying a home or starting a business. At a certain age, perhaps 30, the grandchildren could be entitled to withdraw the money and use it as they pleased.

Harry and Sally liked the attorney's idea. They decided to adjust their wills accordingly and establish a testamentary trust for the grandchildren, which would go into effect after they both died. Harry and Sally also wanted to take steps during their lifetime to help fund the college education of each grandchild. Since 529 plans had been established for all four grandchildren, Harry and Sally decided to begin making annual gifts to those accounts. The current annual exclusion is \$14,000. After Harry and Sally reviewed their retirement plan and estimated future medical costs, they decided to make annual gifts of \$6,000.

**WHAT CONCERNS MIGHT GRANDPARENTS HAVE PERTAINING TO THEIR
GRANDCHILDREN?**

The relationship between a grandparent and grandchild is a special one. Whether it is due to the difference in age or the fact that grandparents already have raised their own children, grandparents tend to view their grandchildren from a unique perspective. Grandparents often have concerns about the following:

Pocket money. They want their grandchildren to have sufficient pocket money to enjoy the little things in life.

- College. They want the grandchildren to receive a college education without incurring enormous student loan debt.
- Automobiles. They want each grandchild to be able to own a car.
- Home ownership. They want each grandchild to be able to buy a home.
- Business. They want each grandchild to be able to start a business, if appropriate.
- Problem grandchildren. Grandparents often want to assist grandchildren, even when they have problems such as drug or alcohol addiction or a history of criminal behavior.
- Grandchildren who need incentives. Grandparents often are interested in helping to motivate grandchildren who otherwise lack drive and self-discipline.

WHAT TOOLS ARE AVAILABLE TO ADDRESS THESE CONCERNS?

There are a number of tools available to help grandparents address their concerns. The tools often can be used in combination to enable grandparents to achieve a variety of goals.

- Gifting. A grandparent can gift each of his or her grandchildren up to \$14,000 a year by taking advantage of the annual exclusion gifts under the Federal Gift Tax law. Gifts for college expenses are exempt regardless of amount, as long as payments are made directly to the educational institution. Gifts for medical care also are exempt, as long as payment is made directly to the provider.
- Specific bequests in a will or trust. A will or trust can provide that each grandchild will receive a fixed amount. That amount may be as little as \$1,000 or as much as \$50,000 or more, depending on the size of the grandparent's estate and the number of grandchildren. Also, depending on the size of the estate, the number of grandchildren and the amount of the bequest, each grandparent can leave a bequest at his or her death, or the bequest can be deferred until the death of the surviving grandparent.
- Wills and trusts can be used to provide for grandchildren with problems, such as addictive illness or criminal behavior. They also can be used to help motivate grandchildren who otherwise lack direction. For example, the will or trust may precondition receipt of funds on such events as graduating from college or retaining a job that pays a certain basic annual salary.
- Percentage share of estate. A grandparent's will or trust can provide that the grandchildren receive a percentage share of the total estate. Typically, the transfer of funds to each grandchild occurs upon the death of the surviving grandparent. If a grandchild is old enough, monies can be left to him or her outright. If he or she is a minor, the monies can be held in trust. A trustee is authorized to use the money for the grandchild's health, education, maintenance or support, or to assist the grandchild in purchasing a home or starting a business. The trustee may be the grandchild's parents. A variation on this strategy is to establish one trust with funds to be divided equally among all grandchildren.
- 529 plans. These plans offer an excellent way to save for college education expenses. A grandparent may establish a 529 plan for the benefit of a grandchild or contribute to one already established.

- Coverdell Education Savings Accounts (ESAs). A grandparent can establish or contribute to an ESA.
- 2503-C trusts. A 2503-C trust can be established by a grandparent for the benefit of a grandchild under age 21.

WHAT SHOULD GRANDPARENTS KNOW ABOUT COLLEGE SAVINGS ALTERNATIVES?

The 529 Plan

Created under Section 529 of the Internal Revenue Code, 529 plans are designed to help families save for their children’s college education. Anyone, including grandparents, may establish these plans and/or make annual, non-deductible contributions to them. Qualified state tuition plans are maintained by each state or state agency; a resident of one state may open a 529 plan in another state. Funds may be withdrawn for qualified higher-education expenses at any qualifying college, university or graduate school and at most community colleges and vocational-technical schools. Educational expenses for private primary schools and high schools do not qualify.

There are a number of important considerations regarding 529 plans:

- Estate tax. Funds in 529 plans generally cannot be included in the estate of either the contributor or the beneficiary.
- Annual exclusion gifts. Gifts to a 529 plan qualify as annual exclusion gifts. In fact, it is possible to “bunch” five years of gifts into one year, as long as no contributions are made in the succeeding four years. Consequently, gifting funds to a 529 plan is a very effective way to remove large sums of money from the contributor’s estate. And the ability to front-load the plan can maximize tax-free income to the beneficiary.
- Income tax. The principal tax advantage of a 529 plan is that the investment income earned in the account escapes federal income taxation and, in many states, state income taxation, provided that the funds are used exclusively for qualified higher-education expenses. The longer the 529 plan is in effect, the more tax-free income is accumulated. Funds not used for college education expenses are taxed as ordinary income to the distributee, with a 10% penalty imposed on the amount withdrawn.
- Contribution limits. The lifetime amount that can be contributed to a 529 plan varies by state. Investments must be made in cash.
- Qualified higher-education expenses. 529 plan funds can be used for tuition, fees, books, supplies and equipment, as well as for room and board when the beneficiary attends school at least half time.
- Change in beneficiaries. Beneficiaries can be changed at any time, as long as the new beneficiary is a member of the family. If a particular grandchild decides not to attend college, or if funds remain in the account after the grandchild graduates from college, another grandchild can be designated as beneficiary.
- Financial aid. Funds in a 529 plan are not counted for purposes of calculating financial aid eligibility.

Advantages and Disadvantages of 529 Plans	
Advantage	Disadvantage
Donor controls account (i.e., can change beneficiaries and withdraw contributions)	Funds not used for qualified education expenses subject to tax and penalty on the earnings portion
Allows for myriad investment options	Stock investments are volatile and may go up or down
Grandparents may establish or contribute to fund	None

Coverdell Education Savings Accounts (ESAs)

A qualified Coverdell Education Savings Account (ESA) is an account dedicated to higher-education expenses. Contributions are made with after-tax dollars, so there is no income-tax deduction to the contributor. The grandchild can withdraw funds tax-free for qualified higher-education expenses. There is a 10% penalty on withdrawals not used for education.

Considerations regarding an ESA include:

- Qualified education expenses. Funds in an ESA can be used for elementary and secondary school (grades K through 12) expenses, including tuition, fees, tutoring, books, supplies and equipment. ESA funds also can be used for qualified higher education expenses, including tuition, fees, books, supplies and equipment, at eligible educational institutions. Room and board is considered a qualified expense provided that the recipient attends school at least half-time.
- Rollover. The responsible individual (account owner) can change the beneficiary at any time to another qualifying “family member” who is under age 30. Family member is broadly interpreted.
- Transfer from an ESA to a 529 plan. Funds in an ESA can be transferred to a 529 plan.
- Age limitation. Funds must be withdrawn fully by the time the beneficiary reaches age 30, or the remaining account will be paid out within 30 days, subject to tax on the earnings and an additional 10% penalty. The penalty does not apply to withdrawals made due to the beneficiary’s death or disability, or to the extent the beneficiary receives a tax-free scholarship.
- Gift tax. The contribution to an ESA is treated as a gift under the annual gift-tax exclusion.

Comparing the Coverdell Education Savings Account (ESA) and the 529 Plan		
	ESA	529 Plan
Annual Contribution Limit	\$3,000	\$12,000 (\$60,000 if five-year annual exclusion gifts are aggregated)
Purpose	Elementary, secondary and college	Higher education only
Date for Contributions	April 15 of the following calendar year	December 31 of calendar year
Income Level Requirement	Yes	No

2503-C Trusts

A 2503-C trust is a trust established to hold funds for a child until he or she turns 21. When contributing to a 2503-C trust, the gift-tax annual exclusion can be utilized. The key to a 2503-C trust is that there are no substantial restrictions on the exercise of the trustee’s discretion to make distributions. Limiting the trustee’s discretion to making distributions for education expenses would be considered a “substantial restriction.”

A gift to a 2503-C trust will be treated as a present interest, as long as the beneficiary of the trust is under age 21 and the following requirements are satisfied:

- The trustee has the power to use the gifted property and income for the benefit of the minor before the minor reaches age 21.
- The minor has the right to withdraw income and principal at age 21.
- If the minor dies prior to age 21, the income and principal is paid to the minor's estate or to persons the minor selects by exercising a general power of appointment.

UNIFORM GIFTS TO MINORS ACT (UTMA)

Gifts under the Uniform Gifts to Minors Act (UGMA) also qualify for the gift-tax annual exclusion. These gifts are irrevocable, because a custodian must be selected and a successor may be designated. The major drawbacks of a UTMA are that the assets in the custodial account must be paid over to the minor, either at majority or age 21, depending on state law. And, if the donor also is the custodian, the assets in the custodial account are included in the donor's estate.

WHAT ABOUT BENEFICIARY DESIGNATIONS?

It is critical to coordinate the beneficiary designations for life insurance policies, retirement plans and annuities to ensure that funds go to the intended beneficiaries. Failure to do this can undermine estate-planning strategies. For example, let's say that a grandfather decides to leave each of his two children one-third of his estate, with the remaining third left in trust for four grandchildren, to be divided equally among them. In order to ensure that this plan will be carried out, the grandfather would need to name both his children and the grandchildren's trust as beneficiaries of his life insurance policies, IRAs and annuities. If only his children were named as beneficiaries, the funds from those policies and accounts would not be available to the grandchildren's trust.



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