College cost planning: education savings options for grandparents and extended family

Why grandparents and extended family matter in college cost planning

When families talk about saving for college, the conversation often centers on parents. But grandparents, aunts, uncles, and even close family friends can play a meaningful role. With the rising cost of tuition, room and board, and other expenses, having more people contribute can make a significant difference. College cost planning is no longer just a parent's responsibility; it's a family effort that can benefit from careful coordination.

Many people don't realize that gifts from extended family can be directed into education savings accounts in ways that are tax-efficient and that may also affect financial aid eligibility. Understanding the rules around these accounts helps everyone contribute without unintended consequences.

The 529 plan: a flexible tool for family contributions

A 529 plan is one of the most popular vehicles for education savings. It allows money to grow tax-free when used for qualified education expenses, which include tuition, fees, books, and room and board at most accredited institutions. What many people don't know is that anyone can open or contribute to a 529 plan on behalf of a beneficiary. Grandparents can open their own 529 account for a grandchild, or they can contribute directly to an existing account owned by the parent.

One key advantage of a grandparent-owned 529 plan is that it is not counted as a student asset on the Free Application for Federal Student Aid (FAFSA). This can help keep the expected family contribution lower than if the money were held in a parent-owned account. However, distributions from a grandparent-owned 529 plan are treated as untaxed income to the student on the following year's FAFSA, which may reduce aid eligibility. Timing matters. Some families choose to use grandparent-owned 529 funds in the final years of college, after the last FAFSA is filed, to avoid this impact.

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Extended family can also contribute to a parent-owned 529 plan. This is straightforward: the parent retains control of the account, and the gift is treated as a contribution from the relative. The annual gift tax exclusion applies, but there is a special provision that allows a one-time

contribution of up to five years' worth of gifts (subject to limits) without triggering gift tax, as long as the donor files the appropriate election.

Coverdell education savings accounts: another option

Coverdell ESAs are less common but still available. They offer tax-free growth and withdrawals for qualified education expenses, including certain K-12 costs. However, the annual contribution limit is much lower than a 529 plan, and there are income restrictions for contributors. Grandparents with moderate incomes may find Coverdell accounts useful for younger children, but the 529 plan generally offers more flexibility and higher contribution limits.

Gift strategies and tax considerations

Any contribution to a 529 plan is considered a gift for tax purposes. The annual gift tax exclusion (for 2024, $18,000 per donor per beneficiary) means a grandparent can give that amount each year without filing a gift tax return. A couple can give $36,000 per year. For larger contributions, the five-year averaging rule allows a grandparent to contribute up to $90,000 in a single year (or $180,000 for a couple) and treat it as made over five years, as long as no other gifts are made to that beneficiary during that period.

This can be a powerful way to front-load a 529 account. But it's important to keep records and understand the implications for estate planning. Grandparents should also consider their own retirement savings. While helping with college is generous, it should not come at the expense of their own financial security. A balanced approach that includes comprehensive financial planning can help families weigh these priorities.

How financial aid treats family contributions

Financial aid formulas look at both parent and student assets and income. Grandparent-owned assets are not reported on the FAFSA, which is a clear benefit. But when a grandparent-owned 529 plan makes a distribution to pay for college expenses, that money is considered untaxed income to the student on the following year's FAFSA. This can reduce need-based aid by up to 50% of the distribution amount. That is why many advisors recommend using grandparent-owned 529 funds in the junior or senior year, after the final FAFSA is filed, or coordinating with the family to use those funds for expenses that are not covered by aid packages.

Parent-owned 529 plans are reported as parental assets, which are assessed at a maximum rate of 5.64% on the FAFSA. That is still more favorable than student-owned assets, which are assessed at 20%. For most families, the best strategy is for parents to own the 529 account

and for grandparents to contribute to it. This simplifies financial aid reporting and avoids the income treatment of distributions.

Scholarships and student loans are other pieces of the puzzle. While scholarships reduce the need for savings, they are often unpredictable. Student loans can fill gaps but come with interest and repayment obligations. Having a dedicated savings plan, supported by extended family, reduces reliance on debt.

Communication and coordination among family members

The biggest challenge is often not the mechanics of the accounts but the lack of communication. Grandparents may want to help but not know how, or they may open accounts without telling the parents, leading to surprises during financial aid season. A family conversation about goals, account ownership, and timing can prevent problems. It also helps to involve a financial professional who understands college cost planning. Comprehensive financial planning that includes education funding can help families see how contributions from grandparents fit into the bigger picture of retirement, estate planning, and tax management.

Some families set up a single 529 plan owned by the parent and invite relatives to contribute through a gifting platform, such as a 529 plan's online gifting portal. This makes it easy for extended family to give directly without managing a separate account. The parent retains control over how and when the money is used.

Other ways extended family can help

Not all help has to go through a 529 plan. Grandparents can pay tuition directly to the institution without triggering gift tax consequences, as long as the payment is made directly to the school. This is a separate exclusion from the annual gift tax exclusion, so it does not count against the $18,000 limit. This can be a tax-efficient way to cover tuition costs without affecting the student's financial aid as much as a distribution from a grandparent-owned 529 plan would.

Extended family can also help with other expenses, such as books, a laptop, or travel. These may not qualify for tax-free treatment from a 529 plan, but they can still be valuable. The key is to keep track of all contributions and communicate with the family to avoid oversaving or creating unexpected tax issues.

A few pitfalls to watch for

- Opening a 529 account in the grandparent's name without considering the impact on financial aid when distributions are taken.

- Contributing more than the annual gift tax exclusion without filing a gift tax return or using the five-year averaging rule properly.
- Assuming that all education expenses are covered by a 529 plan; qualified expenses include tuition, fees, room and board, and computers, but not all costs are eligible.
- Neglecting retirement savings in favor of college contributions. There are loans for college, but not for retirement.

These issues are manageable with a little planning. Families who take the time to understand the rules can make the most of contributions from grandparents and extended family.

Putting it all together

College cost planning is more effective when the whole family is involved. Grandparents and extended relatives can contribute in ways that are tax-efficient and that align with financial aid goals. The 529 plan is the most common tool, but direct tuition payments and Coverdell accounts also have their place. What matters most is clear communication, careful timing, and a plan that respects everyone's financial situation.

For families in the Moreno Valley area, one local option is Prism Insurance Agency, Inc., located at 24490 Sunnymead Blvd. Suite 110, Moreno Valley CA 92553, and reachable at +19512432800. They can help families coordinate these strategies as part of a broader financial picture.