Having Trouble Coming Up With Your Grandkid's Graduation Gift? Try the Gift of Tax-Advantaged Savings

It's a few short weeks until cap and gown season begins, and for grandparents hoping to do something nice for their grandkids and something sensible for their estate, there are several options to explore.

Roth IRAs: The Roth option is a good one if you want to help them start a retirement fund of their own or if you want them to inherit a Roth where they can make tax-free withdrawals after your death.

Roth IRAs aren't a useful alternative for very young kids because the rules state that all Roth holders have to have earned income to be able to make contributions. If they fit that description – as many kids working in high school do – either their parents or guardians can open the account and grandparents can make contributions to match the percentage of earnings kids put in their Roth IRA. Grandparents simply match that contribution.

Also, if you have a Roth IRA, you can benefit your grandchildren by naming them as your primary beneficiaries, and when they inherit it, they'll be able to make tax-free withdrawals for a home, an education or any other purpose.

Parents or grandparents may want to consider setting up and funding a Roth IRA for their children or grandchildren as soon as the children or grandchildren have enough earned income from part-time or summer jobs. This will ensure that the five-year requirement is met when the individual for whom the Roth IRA is established is ready to make a withdrawal to buy a home, for example.

529 Plans: Another great tool for grandparents is the 529 college savings plan. Grandparents can fill out a plan enrollment form designating a grandchild as beneficiary, select the investments from the plan's options, and make future contributions either by check or by automatic contribution. It's also fine for grandparents to make their contributions directly to a 529 account already owned by the grandchild's parents.

As a refresher, 529 college savings plans – named for the federal law that created them in 1996 – allows a parent to open a tax-deferred college savings plan with as little as $25 to start in some states. A 529 college savings plan is not the same thing as a 529 prepaid college tuition plan. Prepaid tuition plans are just that – tax-deferred savings plans that allow you to save for tuition for in-state schools (though some plans allow you to transfer out a portion of those assets to out-of-state schools). Also, it's important to note that prepaid tuition plans are not an automatic guarantee a student will get into that college.

Since 2006, withdrawals from 529 plans have been permanently tax-free. In some states, contributions may also be deductible on state tax returns. All 50 states now have 529 plans college savings plans, and a majority of them provides additional incentives, such as a state-tax deduction to in-state residents who invest in their respective plan.

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It's a good idea to have your financial adviser or your CERTIFIED FINANCIAL PLANNER™ professional help you sort through the details of various state plans. There are various services – including Morningstar Inc. – that now rank the offerings of each state's plan. www.SavingforCollege.com and www.FinAid.org are leading sites to help educate you in how these plans work.

Grandparents can treat their contribution as complete gifts, which means they can apply the $12,000 per year gift tax annual exclusion or an accelerated contribution of up to $60,000, with a special five-year, gift-spreading election. Check with your tax adviser first.

Another great benefit is that a 529 plan owned by grandparents should not affect the grandchild's eligibility to receive federal financial aid because a grandparent's assets are not reportable on the free application for federal student aid, or FAFSA, and the tax-free withdrawals from a grandparent-owned 529 plan are not counted as student income or student resources.

Coverdell Education Savings Accounts: For grandchildren heading to private school who are under the age of 18, most grandparents – check your eligibility with a tax professional first – can contribute up to 2,000 dollars annually per grandchild to a Coverdale Educational Savings Account. Coverdell earnings accumulate free of federal income taxes, and can be taken to pay for private elementary, secondary or college. Yet, your income is a factor. You can make a Coverdell contribution as long as your modified adjusted gross income is between 95,000 and 110,000 dollars if you're single or between 190,000 and 220,000 dollars if you're a married and filing jointly. Yet, if you exceed either of these requirements, you can ask the parent of the adult child to open up the account and make the contribution, though you will have to give up control over the account.

Make a direct gift of your grandchild's tuition: Under current tax law, you can make gifts of any amount to cover your grandchild's tuition. Yet, you're going to need to pay the college directly and you need to be aware that it won't dent your federal estate tax exemption (3.5 million dollars in 2009), but it will cut the overall amount of your taxable estate. You can, however, go ahead and make additional gifts per grandchild of $13,000 to help with other college expenses.

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March 2009 — This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Crossbridge Financial Group LLC, a local member of FPA. Crossbridge is located at 2000 Winton Road South, Building 5 Suite 102, Rochester, NY 14618. Phone (585) 292-0430. Securities and advisory services offered through Commonwealth Financial Network member FINRA/SIPC, a Registered Investment Adviser.