Better Homes and Gardens.

Family Money
“Saving For Your Grandkids”

By James McCommons

Start a financial legacy now by contributing to funds for your grandchild's future. Here's the guide to find your family's best strategy.

When their first grandson was born 21 years ago, Marshall and Dorothy Treado bought him a U.S. Savings bond. They have eight grandchildren now and the 78-year-old couple regularly buys all the grandkids bonds with the understanding that these will be cashed someday for college expenses.

"Besides hugging and kissing them, we think it's the best thing we can do for our grandchildren. We believe in education," says Marshall, a retired Marine Corps officer, who lives in Gaithersburg, Maryland.

Helping with college is the most common way grandparents pass on a financial legacy to the children of their children, but it's not the only method. For example, while the Treado's youngest daughter, Kathy Vermaat, appreciates her parents' gifts of bonds to the grandchildren, she has asked them instead to contribute to 529 and Coverdell college savings accounts that she and her husband, Maarten, set up for sons, Nicolaas, 3, and A.J, 1. Maarten's parents also contribute.

"We think these accounts are a better investment than bonds and a great way for our parents to help out when our own resources are limited. The more invested when the boys are so young, the better the payoff later," explains Kathy, who lives in Michigan.

Many older, middle-class Americans find themselves surprisingly well off-members of what's been called the millionaire-next-door club. They worked hard and prospered in good economic times, lived modestly, saved their money and invested well. Their children, conversely, face a tougher economic road with flat investments, dual careers, and soaring real estate and education costs.

"Many older people have more assets than they need for retirement," says Anthony Domino Jr., president of the Society of Financial Service Professionals. "Once you know you won't outlive the assets, the questions are: 'Who will it go to? Who will control it? What will it be used for?'"

Outright gifts, property transfers, and trusts enable older Americans to move their disposable wealth to their grandkids. In doing so, grandparents lower their own taxable estates and put the money to work in their lifetimes. Here's a look at the most common ways they pass on that financial legacy within their lifetime.

Savings Bonds
Although bonds typically have less earnings potential than other investments, they are backed by the federal government. The interest on Series I Bonds and EE bonds (purchased after 1989) are free of federal taxes when cashed and used for higher education expenses. This exclusion depends upon income, but few college students have enough assets or income to disqualify them from the savings. To learn more about bonds and bond values, visit the U.S. Treasury Department's Web site at www.treasurydirect.gov.

Gifting or Direct Transfer

One grandparent may give $11,000 annually to a grandchild-or any individual-without incurring a gift tax. A couple can gift $22,000. That's per recipient -- meaning if you have four grandchildren, you can gift $88,000 a year. The lifetime gift limit is $1 million -- high enough not to worry most middle-class Americans.

Medical and educational expenses can be gift tax exempt. If you write a check directly to a grandchild's university or medical provider, you won't cut into your annual or lifetime gifting limits, says H. King McGlaughon, Jr., a professor at The American College in Bryn Mawr, Pennsylvania, and a former first vice president in the Wealth Management Services Division at Merrill Lynch.

"My experience is that more and more grandparents make payments directly to the schools," he says. "It makes a lot of sense."

Pre-Paid Tuition Plans

Offered by states or consortiums of colleges, prepaid tuition plans allow you to buy the grandchild's education at today's prices. You can buy credit hours or whole years, paying through installments or in a lump sum.

"These plans stop the inflation clock but they are limited to tuition only-not other college expenses," says McGlaughon.

Also they can limit a grandchild's school selection. If a child chooses not to go to college, most plans can be transferred to another eligible beneficiary. If a grandchild doesn't go to a college within the consortium or plan, the principal-but no interest-is returned to the donors or their

estates.

Custodial Accounts

The Uniform Gifts to Minors Act (UGMA) and Uniform Transfers to Minors Act (UTMA) enable grandparents to set aside assets in an investment account for a minor grandchild. Both UGMA and UTMA accounts can hold cash or securities. Depending on the account provider, other types of assets can be held and managed too.

The custodian -- a bank, financial services company, or even the grandparents themselves -- manages the accounts until the child reaches the age of majority, which is 18 to 25 depending upon the state. The assets then become the grandchild's.

"Because it's an irrevocable gift, there's no way you can control how that money is used once the beneficiary reaches majority age. If the grandchild wants to forgo college and buy a sports car, they can do so," McGlaughon says. "That's the downside."

Custodial accounts incur capital gains taxes on realized gains, and interest earned is taxed upon withdrawal. However, the first $800 in earning is exempt. The next $800 is taxed at the child's tax rate, and amounts of more than $1,600 per year may be taxed at least partially at the grandparent's tax rate.

529 College Savings Plans & Coverdell Accounts

Tax benefits make these saving vehicles extremely popular. Money grows tax deferred (exempt from capital gains) and when withdrawn for educational expenses -- tuition, room and board, equipment, fees and books -- it is tax free. Note: This exemption will expire December 31, 2010, but many people believe Congress will extend this law. Yet, there is no guarantee.

The $11,000 and $22,000 gift tax exclusion limits still apply, but a grandparent can "front load" a 529 and put in up to $55,000 (or $110,000) at one time without incurring a gift tax. However, they can't contribute again for five years without being subject to gift taxes.

"The 529 enables parents and grandparents to build a college fund very quickly," says Domino. "And it's a wonderful place to put a lot of money and get it out the taxable estate."

The plans -- which are offered by individual states -- do not require the child to go to a state school. The money can be used at any higher education institution. If the grandchild doesn't go to school, the plan can be transferred to another beneficiary. Or, the money goes back to the original donor or estate, which pays taxes and a 10 percent penalty.

A downside to a 529 is the limited investment options. Typically, the mutual fund company that

administers the plan for a state offers baskets of "bundled" funds not individual stocks.

Coverdell accounts have no such limitations. Grandparents control and manage the account using a range of investment choices. Also, Coverdell accounts cover pre-college educational expenses, such as private elementary and high schools. The 529 savings plan is limited to higher education.

Coverdell accounts have fallen out of favor, mostly because of their low contribution limits. Each beneficiary may receive only $2000 annually -- in total, not just from one donor. A 529 plan can receive money from many donors and combined contributions max out at $200,000.

Trusts

Lack of control over how a grandchild will use funds concerns many grandparents. Setting up a trust is a way to exert control over the funds, how they will be invested, and the age when the money becomes available. Trusts - favored by folks with high incomes and wealth or the desire to control access and use of funds - have tax advantages but m must be set up and carefully maintained by lawyers and financial professionals. Management fees tend to be high.

Have a Discussion

No matter what strategies you employ to pass on wealth to grandchildren, it's best to have a frank discussion with your family, suggests Domino.

Practically, you want make sure you aren't duplicating their savings strategy or even setting up accounts that already exist. Also, there are matters of equity. What happens when a child doesn't marry or bear children? Second marriages -- by both grandparents and parents -- step children, and step grandchildren may complicate matters, too. Who gets financial help and who doesn't? Finally, there also may be bad feelings from adult children could feel financially bypassed in favor of their offspring. This may be rare because most adult children accept -- even welcome -- their parents' generosity.

"When grandparents help pay for a grandchild's education, it take some of the burden off the parents, freeing them up to save for their own retirement," Domino says. "It's a wonderful gift that most people appreciate."