

Grandma to the rescue: The tax-smart way to cover preschool

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Here's a way for boomers to share the wealth with their children and grandkids: Cover the cost of preschool and shake off gift taxes to boot.

You already know that college expenses are skyrocketing. High-end preschools can be nearly as bad.

Consider that a year of prekindergarten at a prestigious institution, such as the [Grace Church School](#) in Brooklyn, New York, costs \$22,100. Meanwhile, a year at the [Phillips Brooks School](#) in Menlo Park, California, runs \$26,265.

Attorneys say generous grandparents can pay these expenses while saving on gift taxes, although it will take a certain amount of careful planning.

"The numbers are real and they can be significant," said Janis Cowhey, partner at Marcum in New York City.

Preschool versus day care

There are [several ways](#) for grandparents to give money without being subject to gift taxes, said Russell J. Fishkind, partner at Saul Ewing LLP in Princeton, New Jersey.

You can make a gift that's under the annual gift tax exclusion of \$14,000 per recipient.

Alternatively, you can give money away under your lifetime gift tax exemption of \$5.49 million. Be aware that any of this exemption you use up during your life will also reduce the amount you can pass on to heirs free of estate taxes.

Or, you can pay directly for the grandchild's tuition or medical expenses, even if these costs exceed the annual \$14,000 gift exclusion. In this case, all payments must go straight to the provider of these services.

In the context of estate planning, attorneys are familiar with clients using the latter strategy to help pay for college.

When it comes to preschool, however, the situation can be dicey: It's easy to prove to the IRS that your grandchild's college courses are educational.

But can you say the same about your youngest grandchild's prekindergarten?

What's educational?

In order to pass muster as a [nontaxable gift](#), tuition payments to a preschool must be made to an ["educational organization"](#) as defined by the IRS.

"Grandparents can cover these costs as long as this is an educational institution with a regularly enrolled student body," said Fishkind.

"Day-care drop-off doesn't work," he said.

The school must also have a regular faculty in place.

You'll have to take a look at each individual preschool and its curriculum to determine whether it can pass the smell test with the IRS: There's a difference between a school with a structured educational plan and a day care where kids spend the day working on arts and crafts.

"The biggest problem with preschool is that most of the time, but not all of the time, it's considered custodial care, rather than educational," said Cowhey. "It's very facts-specific."

Funding alternatives

If you don't think your grandchild's preschool qualifies as an "educational organization," but you still want to help out, here's what you can do.

- **Pay for preschool, but stay under the limit:** Yes, you can still pay for preschool free of gift taxes, even if it isn't an "educational organization," said Cowhey. Just make sure that you're not paying more than \$14,000 a year — the maximum you can gift free of taxes.
- **Take the long view:** Superfund a 529 college-savings plan with a five-year front load. You contribute up to \$70,000 per beneficiary — the equivalent of \$14,000 annually for five years.
- **Try an intrafamily loan:** If your grandchild absolutely must go to this high-end preschool, and you're unsure whether the IRS will allow it to qualify for tuition in the form of nontaxable gifts, consider a [low-interest](#) intrafamily loan.

"You can loan to your adult kids at 1 or 2 percent, which is way better than a credit card," said Charlie Douglas, partner and director of wealth planning at Cedar Rowe Partners in Atlanta.

Intrafamily loans aren't for novices. You'll want to contact an estate-planning attorney and draft a formal agreement with your adult child if you're going this route.