# Considering Custodial Account Consolidation in 529 Plans

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Many parents dream of sending their children to college but after they consider the cost of tuition, the dream may seem more like a nightmare. According to the College Board's *2009 Trends in College Pricing* (www.trends-collegeboard.com), the average annual tuition and fees at four-year public colleges and universities in 2009–2010 equal $7,020 (in-state), and the average total annual charges, including tuition, fees, and room and board, are $15,213. If that sounds high, consider that the average total tuition and fees at four-year private colleges and universities in 2009–2010 is $26,273, with the average total charges hovering around $35,636. Tuition and fees at public four-year institutions rose at an average annual rate of 4.9% per year beyond general inflation over the last decade, more rapidly than in either of the previous two decades. The increase for private four-year institutions during the same period was 2.4%.

To help cover these skyrocketing education expenses over the years, legislators have created and enhanced programs such as Uniform Gifts to Minors Act (UGMA) accounts, Uniform Transfers to Minors Act (UTMA) accounts and 529 college savings plans to help parents and grandparents save for a child's education. Understanding these rule changes can help those saving for a child's education better select the savings vehicle(s) that can optimize their savings and help them gain greater financial aid flexibility.

## What Are UGMA and UTMA Accounts?

The UGMA and the UTMA are laws that have been adopted by most states. In a state that has an UGMA or UTMA statute, an adult may contribute assets to a child through a custodial account without having to establish a formal trust. Because specific rules pertaining to UGMA and UTMA accounts are determined at the state level, it is important to refer to specific state statutes to determine unique details about how these accounts operate in a particular state, and whether the state offers these accounts under UGMA or UTMA rules.

The main difference between an UGMA and an UTMA account is the scope of allowable investments, with UTMAs permitting a wider range.

### UGMA and UTMA Contributions

Contributions to an UGMA or UTMA account are made on an after-tax basis. In general, there are no limits on how much can be contributed to an UGMA or UTMA account. However, any amount contributed to an UGMA or UTMA account is treated as a completed gift to the beneficiary for gift tax purposes, is an irrevocable gift to the beneficiary, and is subject to the annual exclusion amount on gifts (currently $13,000 per beneficiary per donor for 2009 and 2010).

### UGMA and UTMA Fiduciary Responsibilities

The custodian of an UGMA or UTMA account has the fiduciary duty to manage the account in the best interest of the beneficiary until the beneficiary reaches the age of majority under state law. Although assets may generally be spent on the beneficiary while the beneficiary is still a minor, a custodian should be careful to make sure that any distributions from the account do not violate the applicable UGMA or UTMA statute.[1] When the beneficiary is no longer considered a minor under state law, ownership of an UGMA or UTMA account is transferred irrevocably to the beneficiary, and he or she may use the assets for whatever he or she wishes. Also, in general, a custodian is not allowed to change the beneficiary on an UGMA or UTMA account except in the case of the death of the beneficiary.

### Kiddie Tax Changes Make 529 Plans More Attractive

The kiddie tax requires that a dependent child's unearned income that exceeds two times the standard deduction be taxed at the parent's tax rate. For 2009 and 2010, the amount of the standard deduction is $950, resulting in a taxation threshold of $1,900. The kiddie tax applies to dependents age 18 and younger, as well as to dependent college students under the age of 24 who have unearned income over $1,900.

The kiddie tax may affect UGMA and UTMA accounts. Although contributions to an UGMA or UTMA account are treated as completed gifts for gift tax purposes, income on such custodial accounts may be subject to the kiddie tax. Consequently, earnings on UGMA or UTMA accounts greater than $1,900 for 2009 and 2010 will be taxed at the parent's marginal tax rate, rather than at the beneficiary's rate.

[1] A custodian may make expenditures for the benefit of the minor. These expenses must be outside of normal parental responsibilities (e.g., clothing, food or shelter), and be for the sole benefit of the minor. Note: Because the custodian can exercise this control, assets in an UGMA or UTMA account are includible in the custodian's gross taxable estate until the beneficiary comes of age.

### Financial Aid Implications

One often overlooked disadvantage of contributing to an UGMA or UTMA account to fund a beneficiary's education is that assets in these accounts are treated in the federal financial aid formula as student assets, which are calculated at a much higher inclusion rate (20%) than parental assets (5.64%).[2] Because student assets are counted at such a high percentage, having substantial savings in UGMA or UTMA accounts can dramatically reduce eligibility for needs-based financial aid.

## What Is a 529 Plan?

A 529 plan is a savings plan that is designed to help families save for college costs. These plans are called 529 plans because the rules they must follow to be eligible for federal tax benefits are found in Section 529 of the Internal Revenue Code.

529 plans may be operated by either a state or higher education institution. States may operate both prepaid or savings plans (most states only offer savings plans), and higher education institutions may only offer prepaid plans (about 225 institutions offer prepaid plans). A prepaid plan allows a saver to purchase credits at today's tuition costs. A 529 savings plan, on the other hand, allows contributions to accumulate a cash value that can be used to pay for college education expenses at some time in the future.

### 529 Plan Contributions and Limits

529 plans can only accept contributions made in cash. The annual contribution limit is plan-specific and may vary widely. For example, the maximum contribution per beneficiary for Georgia's 529 plan is $235,000, whereas the maximum contribution for New York's 529 plan is $375,000. As with contributions to UGMA and UTMA accounts, 529 contributions are made on an after-tax basis (that is, no federal tax deductions are allowed for contributions). Contributions may be deductible for state income tax purposes, depending on the state. Earnings are tax-deferred, and distributions are federal-income-tax-free if used for qualified educational expenses. Even though a 529 plan may allow for very large contributions, it is important to remember that these plans are designed to help save for college expenses, not to serve as tax shelters for large sums of money. Therefore, one could run into tax trouble by contributing sums that clearly exceed what a student would reasonably need to pay for college expenses and then taking large nonqualified withdrawals (which would be subject to ordinary income tax and a 10% federal penalty) at a later point. However, given the cost of many private colleges and graduate schools, the amount a person might reasonably need to pay for higher education can be quite high, and assets in 529 savings plans can be moved down to pay higher education expenses of future generations through beneficiary changes.

### Fiduciary Responsibilities

When someone contributes to a 529 plan, the investments are limited to those offered by the plan's manager. Most plans offer preset asset allocation portfolios and so-called single-fund portfolios that allow the account owner to customize the investment allocation. By federal regulation, the investor is limited to one investment reallocation per year. Under an individual registration, the account owner has complete and total control over the account, yet does not have any fiduciary responsibility. This allows the account owner to revoke the assets or name another family member as the beneficiary at any time, and to solely determine the "if, when and how" of asset usage. Therefore, for donors who want to keep control over college savings, 529 plans have an inherent advantage over UGMA and UTMA accounts. (With an UGMA or UTMA account, irrevocable control transfers to the beneficiary upon reaching the age of majority. Note that even when an UGMA or UTMA account is transferred to a 529 plan, it retains the ownership characteristics associated with UGMA and UTMA plans.)

Some states' 529 plan accounts may be operated as UGMA or UTMA accounts, and in the case of a transfer of assets from an UGMA or UTMA account to a 529 plan, they must be treated as such. In that case, the irrevocable nature of the gift and the fiduciary responsibility of the custodian continue to apply. This is true for trust registrations as well. However, due to recent legislation, student assets (for example, UGMA, UTMA and trust) held within a 529 plan are not considered student assets for federal financial aid purposes.

### Accelerated Gifting

A unique and exclusive tax benefit available to those who contribute to a 529 plan is the ability to make contributions in a single year that are greater than the annual gift tax exclusion without incurring federal gift tax up to a maximum of $65,000. To do so, the donor must elect to treat the contribution as five pro rata gifts over a five-year period. This means that in any single year, a donor may contribute more than the annual gift tax exclusion to a 529 plan account, and elect to spread the gift evenly over a five-calendar-year period for federal gift tax purposes by filing federal gift tax Form 709.

[2] www.finaid.org/savings/childtaxes.phtml

Accelerated gifting also removes the future growth from estate tax. If a donor elects to treat a donation as five separate, equal gifts to avoid gift tax, then the donation will be excludable from his or her estate on a pro rata basis. To fully avoid estate tax, the donor must survive to January 1 of the fifth calendar year.

It is important to keep in mind that with 529 plans, investors may be investing in securities, and there is always the potential of losing money when one invests in securities.

Another great advantage that 529 plans have over UGMA and UTMA accounts is that no federal taxes are due on income earned while assets are in the plan. This benefit not only reduces a contributor's annual tax payments, it also reduces his or her tax paperwork. In addition, no federal taxes are due on assets that are used to pay for qualified educational expenses.

### Financial Aid Implications

Historically, 529 plan assets were considered assets of the account owner for the purpose of calculating financial aid need. Effective for the 2009–2010 school year, 529 plans owned by a student or parent are treated as parental assets. Parental assets are subject to financial aid inclusion, but are included at a lower rate than student assets.

## Transfers of UGMAs and UTMAs to a 529 Plan

There are two compelling reasons to transfer UGMA and UTMA assets to a 529 plan: 1. better treatment for financial aid purposes, and 2. better tax treatment with respect to investment income. UGMA or UTMA custodial accounts are more advantageous when there are other, broader intended uses for the assets beyond covering higher education expenses.

## Federal Financial Aid Consideration

One way to provide greater financial aid flexibility is to transfer the assets in an UGMA or UTMA account to a 529 plan, because 529 assets are not treated as student assets, even if they are otherwise covered under the rules that apply to UGMA or UTMA accounts. Transferred assets are factored into the federal financial aid formula at the parental rate of 5.64%. This change took effect for the 2009–2010 and later school years as a result of the College Cost Reduction and Access Act of 2007. Also, the assets will be spread across the parent's expected contribution (which is divided by the number of children in college, rather than straight-lined to the child).

## Better Tax Treatment

As was mentioned previously, the income on UGMA and UTMA accounts is taxable. In contrast, income in a 529 plan is tax-deferred, and is tax-free at the federal level if distributions are taken for qualified educational expenses.

## Other Considerations

Since 529 plans can only receive cash contributions, a transfer from an UGMA or UTMA account to a 529 plan that accepts transfers may require the liquidation of noncash assets. In some cases, this may create taxable income in the year of the transfer, so custodians should consult with a tax advisor before initiating such a transfer.

Clients should take into account any potential expenses, sales charges and/or penalties for selling or buying investments.

After the assets are transferred to the 529 plan, they will be treated like 529 assets for tax purposes from that point forward. However, because the transferred amounts originated in an UGMA or UTMA account, they will be treated as an UGMA or UTMA account for the purpose of how the assets will be transferred to the beneficiary (that is, they are treated as an irrevocable, completed gift, and will become the property of the beneficiary when the beneficiary reaches the age of majority under state law). Another aspect of such transfers is that the beneficiary may not generally be changed except in cases of the death of the beneficiary.

## Conclusion

Given the high current cost of education, and the likelihood that these costs will continue to skyrocket, it has become more and more important to create a formal savings plan to help ensure that there will be sufficient assets available when a child goes to college. This plan should look at several things, including whether:

- A child is likely to go to a public or a private college
- The parent or grandparent would like to maintain control over college savings after a child reaches the age of majority
- Various savings options will affect federal financial aid calculations, and specific educational institution financial aid calculations
- There are tax implications of saving using an UGMA or UTMA account vs. a 529 plan
- Contributions can be spread over multiple years for gift tax purposes
- There may be state tax advantages to saving in a 529 plan vs. an UGMA or UTMA account
- There are different estate tax implications connected with saving in a 529 plan vs. an UGMA or UTMA account

Once a thorough analysis of these issues has been done, parents and grandparents will be in a much better position to select the college savings vehicles that can best meet their college savings and estate planning needs. Moreover, consolidation of existing college savings in a 529 plan may prove to be an enticing option.

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CRS-49/28902-1209 09/AR98832