



Should You Fund a 529 with UGMA/UTMA Assets?

By Tony M. D'Andrea, Jr., CFP®

If your clients are using an UGMA or UTMA account to save for a child's college education, you may consider having them transfer all or part of those assets to a 529 plan. Converting a taxable account (UGMA/UTMA) to a tax-deferred and potentially tax-free investment vehicle (529) may expedite asset growth and help them meet the ever-increasing cost of their child's higher education.

An UGMA/UTMA does not involve the same tax benefits as 529 plans. In an UGMA/UTMA, earnings above \$850 are taxed at the child's rate when the child is 18 or older (the first \$850 is exempt). Prior to that age, the "Kiddie Tax" rules apply. These rules allow the first \$850 of earnings to be exempt. The next \$850 is taxed at the child's rate, and earnings in excess of \$1,700 are taxed at the parent's rate. Once an UGMA/UTMA is converted to a 529 plan, earnings grow tax-deferred and distributions are tax-free from federal and most state income tax if used for qualified higher education expenses.* Some states also offer state tax deductions for contributions to in-state 529 plans.

Besides the tax benefits, it is important to consider several other implications of an UGMA/UTMA-to-529 transfer. First, assets in the original UGMA/UTMA account must be liquidated before contributing to a 529 plan. This could trigger capital gains or other tax consequences. Also, 529 plans funded by UGMA/UTMA accounts retain certain characteristics of an UGMA/UTMA while foregoing some benefits of 529 plans.

For example, a regular 529 account allows the account owner to:

- Control assets regardless of the beneficiary's age;
- Consider plan assets as his or her own for financial aid purposes;
- Change the beneficiary at any time; and
- Withdraw plan assets for any reason.

However, with a 529-UGMA/UTMA account:

- The beneficiary gains control of the assets at age of majority;
- The account is still considered the beneficiary's asset for financial aid;
- The account owner cannot change the beneficiary; and
- Withdrawals can only be used for the beneficiary, as specified under the UGMA/UTMA statute.

Therefore, the tax advantages of a 529 plan should be the main reason for moving UGMA/UTMA assets.

Another thing to keep in mind is that the purpose of 529 plans is to provide a savings place for higher education. Expenses such as the cost of braces, high-school supplies or any other pre-college expense will not be paid for by the

529 without taxation and a 10 percent penalty on earnings. As such, the custodian may want to leave the portion of UGMA/UTMA assets meant for pre-college expenses in the account and only transfer the amount designated for college costs to a 529 plan. If the custodian plans on making additional contributions in the future (contributions intended for college expenses), a new account separate from the 529-UGMA/UTMA should be opened in order to take advantage of all the benefits that a 529 offers.

Of course, this brief article is no substitute for a careful consideration of all of the advantages and disadvantages of this matter in light of you or your clients' unique, personal situation. ■

** Withdrawals for qualified education expenses became federally tax-free effective Jan. 1, 2002. The provision was made permanent as part of the Pension Protection Act recently signed into law by President Bush.*

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