Tax-Smart College Investment Gets Better (Again)

New, Favorable UTMA Treatment

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The 529 College Savings Plan offers unique benefits not found elsewhere in current law or tax rules. Since its creation under the Small Business Job Protection Act of 1996, its flexible and tax-advantaged savings programs have become an investment platform of choice; by the end of 2009, total assets had surpassed $111 billion.¹ Not just for upper-bracket taxpayers, 529s appeal to anyone seeking to retain control over their gifts, reduce potential estate tax, maximize financial aid eligibility, or simply put tax-free money aside for college. This article describes recent changes in the legal and tax treatment of 529s that may confer benefits to your clients.

Financial Aid Treatment for 529 UTMAs

A recent change in federal law has made it easier for college students with UTMA accounts to qualify for federal financial aid eligibility by transferring those funds into a 529.

The Uniform Transfer to Minors Act (UTMA) (formerly the Uniform Gifts to Minors Act or UGMA) is a statutory trust offered in every state, Guam, the Virgin Islands, and Washington DC. Before 2009–2010, the main economic motivation to transfer existing UTMAs into 529 plans was to take advantage of qualified tax-free withdrawal provisions or creditor protection (in some states).

But in mid-2006, Congress proposed classifying UTMA-funded 529s as parental assets instead of student assets for the purposes of financial aid eligibility. The resulting College Cost Reduction and Access Act of 2007, effective July 1, 2009, may provide favorable financial aid determinations when a UTMA is transferred into a 529 plan. Qualified education benefits, such as 529s, are treated as student assets if the student is independent or parental assets if the student is dependent, regardless of whether the student or parent owns the account.

Under this incentive, a dependent student’s UGMA/UTMA assets held within a 529 plan are considered parent-owned, which generally results in a more positive financial-aid determination. This rule always has applied to non-UTMA 529 plans.

Attribution of Assets

The federal college financial aid application process uses a standard format to determine an applicant’s ability to afford college. It uses available sources of income and assets to determine eligibility and need, and student-owned assets such as funds in UTMAs generally are considered to be 20-percent available to pay for college.

As a result, a student’s UTMA assets may result in well-intentioned gifts and employment savings having the unintended consequence of reducing financial aid awards and even the ability to afford college.

For example, assume two students who qualify for a $10,000 first-year needs-based loan or grant. All other things being equal, the student with no savings could receive the full $10,000 benefit, and the student who had savings and gifts amounting to $50,000 would get nothing because the award would be offset by 20 percent of the accumulated $50,000.

On the other hand, only 5.64 percent of parental assets generally are considered available for education funding. This means that families can have four times as much savings as students and the financial aid award would be the same.

This disparity may discourage students from saving or keep relatives from making financial gifts to students. Indeed, many conscientious parents have discovered too late the potential error made by funding UTMAs. Once a UTMA gift has been made, it cannot be undone. It can, however, be spent for the benefit of the minor child so long as the expenditure is not used to meet a legal obligation of the parent or guardian.

For minor children, this means that UTMA funds generally can’t pay for the five basic necessities (food, clothing, shelter, education, and medical treatment that parents must legally provide).

Tax Advantages

Financial aid applications also examine the student’s taxable income. Because qualified 529 distributions aren’t taxable, they aren’t reported as income and generally aren’t reported on financial aid applications. Because 529s must be funded with cash (not securities), investors must consider the capital-gains cost of liquidating UTMA or other trust assets to fund a 529.

(Caveat: Financial aid departments may change their criteria for reporting of 529 distributions.)
The new law also reclassified prepaid tuition plans as parental savings. Previously these savings plans were treated as resources that reduced student need on a dollar-for-dollar basis. In the past, this formula caused a significant reduction in eligibility for subsidized loans, work-study, and certain grants.

The federal income-tax-free nature of qualified 529 plan withdrawals also offers an economic advantage over UTMA. For example, assume a $5,000 annual contribution over an 18-year period with a hypothetical 10-percent annual return. The 529 effectively grows to nearly $278,000, while the UTMA or other taxable account effectively grows to $219,000–$233,500, depending on the tax bracket. This is why custodians may choose to transfer UTMA assets earmarked for education into 529 plans.²

The above example does not include state benefits that may be available, such as state income tax deductions for 529 contributions. Potential investors should consider such state benefits, which may be conditional upon certain requirements. Most states that offer tax deductions for 529 plans also have recapture provisions if you change states or make nonqualified withdrawals.

Avoiding Taxation

When used for qualified higher education purposes at public, private, vocational, in-state, or out-of-state schools, contributions and gains in a 529 avoid taxation. The definition of “qualified higher education expense” includes tuition, room and board, student fees, computers,³ and books plus anything the financial aid office includes under its expense definition. Room and board withdrawals are permitted up to the amounts considered for federal financial aid purposes for on-campus accommodations, even if the student lives at home or off-campus. Expenses for special needs students also may be permitted.

If funds are withdrawn for nonqualified purposes, the general rule requires the recipient to be assessed federal income tax on any gains plus a 10-percent penalty on the total amount of the gain withdrawn. Although gains will be taxable as income, an exception allows a waiver of the 10-percent penalty for withdrawals because of the beneficiary’s death or disability.

Take-Backs and Beneficiary Changes

The 529 plan is well-respected by those concerned with transferring large amounts of wealth to young adults and wishing to maintain a good deal of flexibility. Though it is considered a completed gift for tax purposes, it has a unique status when it is newly funded—i.e., when its assets aren’t the result of a UTMA transfer: Grantors retain the ability to change beneficiaries, control distributions, keep creditors at bay, and even take the money back for their own use. Beneficiaries can be substituted with other family members at will (as can transfers from state-to-state or to private prepaid tuition programs). Funds can be used for post-secondary education in any state, regardless of which 529 plan is chosen.

Beneficiary changes, also known as rollovers, can be made at any time so long as the new beneficiary is a member of the family of the previous beneficiary. Permissible family member rollover beneficiaries include sons, daughters, brothers, sisters, nephews, nieces, first cousins, certain in-laws, and spouses. The ability to change beneficiaries means that a single 529 can be used to pay tuition costs for more than one student.

These control and beneficiary changes don’t apply to 529 assets funded with proceeds of a UTMA account because those assets irrevocably belong to the child; i.e., UTMA beneficiaries cannot be changed and, when these beneficiaries reach the age of majority, UTMA 529 account beneficiaries legally assume control over the assets.

UTMAs and Trusts vs. 529s

For many savers, transferring a UTMA custodial account to a 529 plan has other advantages, too. To assure compliance with UTMA rules (i.e., ownership at the age of majority), 529s keep UTMA funds segregated. This helps students avoid the “kiddie tax” and, in many states, provides creditor protection.

Investors also should consider that UTMA assets are available for many more uses than 529 assets, including noneducational expenses. Note again, however, that UTMAs for minor children are not available to defuse legal obligations of the parent—generally defined as necessary medical, food, clothing, shelter, and education expenses up to the age of majority.

A portion of a trust usually can be earmarked for contribution to a 529 plan, though the 529 portion of the assets must conform to the terms of the trust (just as when UTMA funds are transferred to a 529). As a result, eventual control by the student cannot be modified beyond the original format of the trust. However, placing trust (or UTMA) assets in a 529 underscores the custodian’s intent that the purpose of these funds is to pay for college.

Special Estate-Tax Advantages

For estate and gift-tax purposes, 529 contributions allow donors to combine five years of annual gifting allowances to make a single-year contribution of up to $65,000 per beneficiary’s account (or $130,000 for a married couple, filing jointly). Because the gift is sheltered from transfer taxes by using five years worth of the annual gifting exclusion ($13,000 per year for 2010), no further gifts can be made under the gifting allowance during the five-year period. This front-loading strategy allows considerable sums to be transferred quickly out of an estate. If the donor doesn’t survive the five-year period, the unamortized amount will be included in

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the contributor’s gross estate although earnings on the funds are excluded from the grantor’s estate.

Differences in 529s among states can make shopping for one a valuable exercise. Differences in maximum state contribution limits, state taxation of withdrawals, deductibility of contributions, investment choices, and plan expenses are worth exploring. Investment choices generally are limited within a particular 529 plan, but the ability to roll over plans from state to state can provide some additional choice. Even so, the nearly unlimited investment choices available in UTMs may provide an advantage over 529s and also should be considered.

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Disclaimer: Please consider the investment objectives, risks, charges, and expenses carefully before investing in a 529 savings plan. The official statement, which contains this and other information, can be obtained by calling your financial advisor. Read it carefully before you invest.

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Endnotes


2 This example is hypothetical and provided for informational purposes. It is not intended to represent any specific return, yield, or investment, nor is it indicative of future investment results.

3 Current regulations only allow computers as a qualified expense if incurred in 2010.