

## Why We Favor UTMA's over 529s

Your options for saving for children's college educations are numerous, and one size does not fit all. Below, we outline the major options. The right option depends on ages of your children, family income, potential for financial aid, expected cost of college, and other factors. Our analyses and experience, however, have us strongly recommending that UTMA (Uniform Transfer to Minors Act) accounts, also known as custodial accounts, are the best way to go for the majority of our clients.

***UTMA's (Custodian Accounts)*** – Investments are held in the name of a minor, but are managed by the custodian (such as a parent). This arrangement provides tax benefits, especially for higher-income families because they shift capital-gains taxes to their lower-income children. There are no income restrictions, but contributions over \$13,000 a year per parent are subject to gift tax, and in some instances, the assets remain in the parent's estate.

A key advantage of UTMA's is that reinvested dividends and the account growth are tax-free until the child's annual unearned income exceeds \$950. Only then may a child pay any taxes on dividends and capital gain, if they are in the 25% income tax bracket or higher. So the threshold for annual UTMA earnings without significant taxes effectively is \$1,900. Only at that point, and only if the child is under 18 years old, does the tax bleed over to the parent's rate. After 18, the child is taxed as an individual, not at the parent's rate. Lastly, the reinvested dividends and capital gains add to the account's basis, making withdrawal potentially tax-free.

The combination of lower expenses, few rules, and greater freedom makes this option our overwhelming first choice.

UTMA's present three drawbacks. One, the gifts are irrevocable. Two, the child assumes control once a legal adult, and thus may spend the money elsewhere besides college. Three, the assets typically count more heavily against financial aid, though some colleges are changing that.

***Coverdell Education Savings Accounts*** – We rank this alternative second. In these accounts, you can contribute up to \$2,000 a year per child, but there are income restrictions: \$190,000 - \$220,000 phase-out for married couples; and \$95,000 - \$110,000 phase-out for singles. The income thresholds can be circumvented using other qualifying donors (e.g., grandparents or siblings). Earnings are federal-income-tax exempt if used for qualified education expenses. Coverdells offer many more investment choices than 529 plans and often have lower expenses.

Coverdells can be a good option for people who can save only a small amount each year, or who may want to fund a Coverdell before moving on to other alternatives. Because a Coverdell account is considered the parent's asset instead of the student's, the student is eligible for more financial aid. This is a good but limited second choice.

**529 College Savings Plans** – These are our third-ranked recommendation, most applicable to benefactors with notable wealth. While 529 plans can be an especially good alternative for high-income families wishing to save a substantial amount for college, investment options usually are limited, and management fees usually are higher. Features of these state-run plans include:

- Investments grow tax-deferred, and withdrawals for qualified college expenses are currently free of federal tax through 2010;
- Some states give tax breaks on the contributions;
- Over \$200,000 can be invested in many plans, and as much as \$110,000 at one time;
- Investor retains control and can change beneficiaries;
- No income restrictions;
- Their impact on financial aid is the same as Coverdells and smaller than many alternatives;
- There are restrictions on what the funds can be used for, and government approvals are required.

Our judgment is that 529s should be used as the third alternative, not the first. They are particularly useful for wealthy grandparents with multiple beneficiaries.

There are other college funding choices that are occasionally viable but are not used often, and then only in special circumstances. These include:

**Pre-paid tuition plans** – Under these plans, you can buy part or all of a school's future tuition bill at today's prices. Earnings from either private or public plans are tax-exempt. Ohio does not offer these plans for its public colleges. Originally only offered by certain states, prepaid tuition plans now are also available through a coalition of nearly 200 private schools.

They can be a good option for conservative investors who want to lock in tuition costs and who know what college their children will attend. There are penalties for changing your mind about a state school, but there is more flexibility under the private plan. Also, under current rules, prepaid plans unfortunately reduce financial aid dollar-for-dollar.

**Series I and EE Savings Bonds** – The interest earned from these bonds is free of federal tax as long as it is used to pay for tuition and fees, the parents hold the bond title, and parental income is not too high. But the benefits may be reduced

by other education tax breaks (e.g., HOPE Scholarship), and the rate of interest earned compares poorly with the double-digit rate of increases in tuitions.

***Taxable Investments in the Parent's Name*** – The advantages include nearly unlimited investment options, no income restrictions, retention and control of the assets, and the flexibility to use the assets other than for college. The major disadvantage is the taxes on earnings. You can minimize that by gifting the assets to your child at college time and having them sell the assets, although you could face *gift* taxes.

***Individual Retirement Accounts*** – Money taken out of a traditional IRA and used for qualified education expenses is free of the 10% early-withdrawal penalty (but not ordinary taxes). Withdrawals of Roth IRA contributions are tax-free, and even the earnings may be tax-free in some situations.