Differences between a 529 Plan and UTMA Account

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My parents used a UTMA account to save money for my college expenses when I was growing up. It was really the only way back then to save for a child's education. Today, the popular option is the 529 plan. You might have heard of both types of accounts, but don't know the differences between the two. I will break down each account below and go over the benefits and drawbacks to better help you decide which option is right for your situation.

UTMA

A Uniform Transfer to Minors Act account (UTMA account) is a way for children to have ownership of assets-because minors are not legally allowed to own money or property. Because of this, each state has developed this type of account to allow a child to have ownership of assets.

A UTMA account is a custodial account. The account is the child's- reported under the child's social security number; however, the custodian, usually the parent, has a fiduciary responsibility to manage the account for the benefit of the child. The custodian acts on the account (by making deposits, withdrawals and trading) until the child reaches the age specified by your given state.

For UTMA accounts, the child gains full ownership of the account when they turn 18 or 21 years old, depending on which state they live in.

Income Tax Considerations

Since the account is opened using the child's Social Security number and the interest on the account is taxed to the child and possibly to the parents.

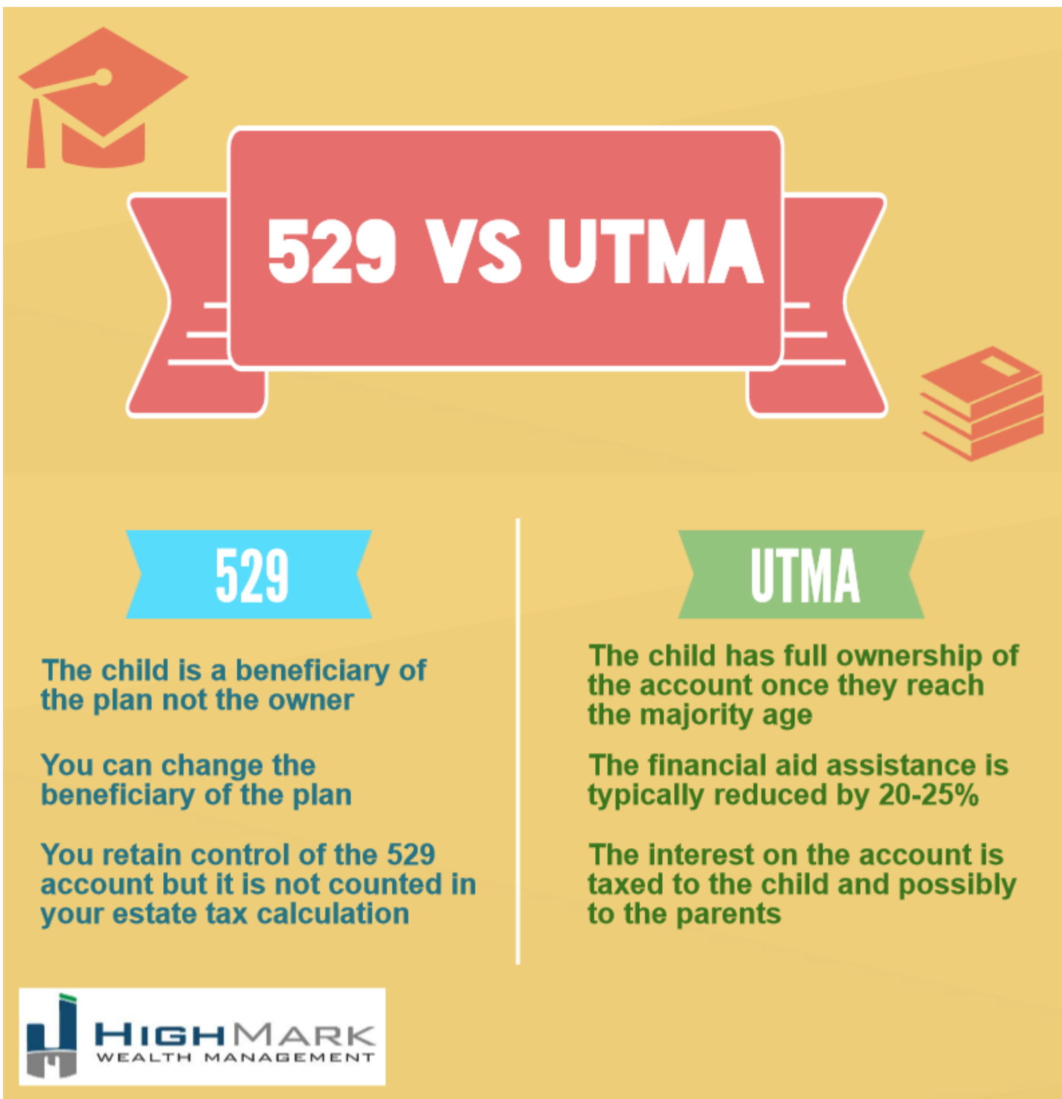
Cons – UTMA Accounts

The main drawback is the child has full ownership of the account once they reach the majority age. This may not seem like a big deal; however, once it is their money they can do anything they want with it. For example if the account has a $100,000 balance when little Jimmy or Sally reaches 18 years old they can buy a car, take a trip to Europe or pay for college. It's an irrevocable gift to the child that you can't take back. We all think that we are raising little angels, believe it or not, may not always be the case.

Also, when applying for financial aid, the financial aid assistance is typically reduced by 20-25% of the UTMA balance. The UTMA is used before college for the benefit of the child.

Pros – UTMA Accounts

A benefit to an UTMA account is the reduced taxes. The first $1,000 (2014) of unearned income (dividends and interest) is not taxed. The next $1,000 (2014) will be taxed at the child's tax rate. Everything above $2,000 (2014) is unearned income and will be taxed at the parent's tax rate; this is called the Kiddie Tax Rule. This means if a child's interest plus dividends plus other investment income total more than $2,000 (2014), part of the child's unearned income will be taxed at the parent's tax rate instead of the child's tax rate. It does not include income the child earned from a job or self-employment. Once you hit the $2,000 (2014) mark, the benefit of an UTMA account in terms of tax savings goes away.



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529 Plans

A 529 Plan is a way for parents to save for their child's college education. There are two main types of 529 plans, a prepaid program and a savings account. For this post I will break down the 529 savings account.

For a 529 plan, when you make contributions your money grows tax-free. When the money is withdrawn from the account, assuming the money was used for qualified educational expenses there will be no taxes paid. Qualified educational expenses include tuition, fees, books, supplies and equipment, and reasonable costs for room and board – for those enrolled at least half-time. Non-qualified education expenses include insurance, sports or club activity fees, computer (unless the school requires it), transportation costs, repayment of student loans, and room and board in excess of the amount the school includes in "cost of attendance."

You can contribute as much as you want to a 529 Plan up to the state maximum (usually around $250,000); however, any contributions that total more than $14,000 in a given year may be subject to the gift tax. Section 529 plans offer a special gifting feature. Specifically, you can make a lump-sum contribution to a 529 plan of up to $70,000, elect to spread the gift evenly over five years, and completely avoid federal gift tax. This is provided no other gifts are made to the same beneficiary during the five-year period. A married couple can gift up to $140,000.

When to withdraw

Take withdrawals in the same calendar year that the qualified expenses were paid. This ensures the qualified withdrawal matches up with the qualified expense, per the IRS rules.

Cons – 529 Plans

If the profit is withdrawn for non-qualified educational expenses, it will be taxed as ordinary income and is subject to a 10% penalty. You can find a list of the exceptions to this penalty on the IRS website.

Each state has its own 529 Plan, some are better than others. This can make it confusing when picking out which state's plan is the best one for you. **Contacting a financial adviser** is the easiest way to figure out which plan will work for you.

If you have a chance to qualify for financial aid, the 529 assets owned by the parents are included in the federal financial aid calculation. The assessment rate on the parent's assets is currently a maximum rate of 5.34% of total assessable assets.

Pros – 529 Plans

The primary benefit is the child is a beneficiary of the plan and not the owner. The benefit is the assets in the account are not the child's; therefore the parent has full authority over the account.

Another benefit is that you can change the beneficiary of the plan. For example you have an account for little Jimmy and for whatever reason he decides not to go to college. All you simply have to do is change the beneficiary from Jimmy to Sally and she can now use the money for college. Additionally, you can even change the beneficiary to your niece or nephew.

Each state has its own 529 plan and you can choose to open whichever state plan you want. For example if you live in Texas you don't have to open up the Texas 529 Plan. Also, if you live in Texas and use a Texas 529 Plan, your child does not have to enroll in a school in Texas. They are allowed to go to any college they want to.

Also, a major benefit is you retain control of the 529 account but it is not counted in your estate tax calculation.

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