Custodial 529 College Savings Accounts

Prepared by Christopher P. Bruhl CLU CFP® prepared on 11/07/2013

The title *Custodial 529 College Savings Account* refers to a standard 529 College Savings Account funded by a Uniform Trust For Minors Account (UTMA) - money already owned by a minor child. Changes to the beneficiary are generally not allowed (nor advised), as money held in a UTMA is legally owned by the child.

Funds held in a UTMA enjoy broad flexibility in both investment strategy and ultimate use. Short-term investment gains of up to $1,000 per year can be totally sheltered from tax.

Once the funds are held by a Custodial 529, investment strategies can be adjusted only once per calendar year and qualified uses are limited to tuition, room and board at accredited institutions of higher learning. When used to cover qualified expenses, all investment gains can be received free of federal income tax.

Impact of Student Financial Aid:

The Custodial 529 account is reportable on the FAFSA, but not as a student asset assessed at the usual 20% student rate. Instead, it is reported as a parental asset and assessed at the lower 5.64% maximum parental rate. The fact that an asset owned by one party (in this case the student) is treated as if it were owned by another (the parents) is highly unusual in the financial aid laws. A 529 account is treated as a parental asset whether owned by the parent, the child through an UTMA, or by the child directly.

When filing the FASFA, the federal government requires that you must include as parental assets all of the 529 accounts you own for anyone else, due to the ownership and control of those accounts. This is unfortunate, as the funds set aside for a younger child's college education will have a negative impact the financial-aid eligibility of the older child.

When the student’s parents are divorced, only one of them is responsible for completing the FAFSA. This parent is the one with whom the student lived the most during the 12 months ending on the FAFSA application date (or failing that, the parent who provided the most support). This parent is referred to as the ‘custodial parent’, and the other parent as the ‘non-custodial’ parent. Only the custodial parent’s income and assets (plus the step-parent’s income and assets, if the custodial parent has remarried) must be reported on the student’s FAFSA. The non-custodial parent’s income and assets are ignored.

When the non-custodial parent owns a 529 plan, that 529 plan is not reported as an asset on the student’s FAFSA, but any distributions from such a 529 plan are reported as untaxed income to the student.

This can have a severe negative impact on the student’s eligibility for need-based aid. There are two effective workarounds. One involves changing the account owner from the non-custodial parent to the custodial parent. The other involves waiting until the student’s senior year in college to take a distribution from the 529 plan account, when there will be no subsequent FAFSA filings.

Income Tax Implications:

A dependent child can report as much as $1,000 in investment income in 2013 without being subject to federal income tax. If the UTMA account is generating income under this amount, the tax shelter can prove beneficial at tax time.

When existing UTMA accounts are generating more than $1,000 in annual income, the analysis favors the Custodial 529 option. Income between $1,000 and $2,000 remains taxable at the child's relatively low tax bracket. As income rises above the $2,000 annual level, it may become exposed to tax at the parents' marginal tax bracket.

This rate bump is known as the "Kiddie Tax" and it applies to the following three groups of taxpayers: (1) children through the age of 17; (2) 18-year olds who do not earn more than one-half of their own support; and (3) 19- to 23-year-old full-time college students who do not earn more than one-half of their own support.

The impact of tax on Capital Gains must also be factored into the equation. The UTMA account structure does not shelter long-term capital gains (LTCG) from tax. To transfer funds into a Custodial 529 Account generally involves a liquidation of existing assets. This could trigger a taxable event and the impact needs to be calculated into the broader equation. Keep in mind that this tax on LTCG will eventually be paid on UTMA assets as investment positions are re-balanced or cash is raised to cover tuition bills. The issue becomes one of timing – is it best to pay the tax now or to defer it into a future year?

Implications for Residents of States that Provide a State Tax Benefit for 529 Contributions:

Ten states now offer income tax deductions for contributions to Section 529 accounts. This tax benefit can boost short-term returns on contributions. The longer-term impact must be weighed against plan expenses and results delivered by investment management to assess its full value.

As an example, look at the impact of the tax deductions for Colorado residents. Contributions to CollegeInvest Accounts are deductible from Colorado state income tax in the tax year of the contribution, up to your Colorado taxable income for that year.

Considering that the top income tax bracket for Colorado residents is 4.63%, every $1,000 contributed to a Colorado Section 529 plan could save a maximum of $46 at tax time. In other words, receiving the deduction is equivalent to a 4.63% bonus on the amount contributed.

As with most states, distributions from the Colorado Section 529 plan that are used for qualified education expenses are not subject to taxation. Non-qualified distributions will be subject to tax and a possible “recapture” of any deduction previously received.

In a hypothetical example, the tactic might look something like this: A UTMA account is transferred into the CollegeInvest account in December, prior to the child’s graduation from High School. As a Custodial 529, the account value is reported as a ‘parental asset’ when the FASFA is filed in January. This can have a significant positive impact of the calculation of the Expected Family Contribution (EFC).

When the tax return is filed in April, a deduction is available on the Colorado State Form 104. With only a short time between December and the first tuition bill in August, the funds are held in a cash account to reduce market risk. The effective return on investment for those 8 months exceeds 6% on annual basis.

The reduction in EFC and the low-risk return of 6%+ combine to create a powerful boost to cash prior to when it is needed most – just as those tuition bills start arriving.

And now to keep the attorneys happy, the disclosure: This information is provided as an example of what is possible and not representative of any specific investment or planning situation. This information is not intended to be a substitute for specific and/or individualized tax advice. We suggest that you discuss your specific situation and tax concerns with qualified tax counsel.

Sources:

Savingforcollege.com
Finaid.org
Fastweb.com
About.com
CollegeInvest.org

<<<<<<<<<<<<<<<<<<<<<<<<<< 0 >>>>>>>>>>>>>>>>>>>>>>>>>>

Traditional Financial Planning will often focus upon the management of financial assets.

Multi-disciplinary Financial Planning broadens the approach to include Risk Management Strategies.

Life-Based Planning takes the process a step further to define the goals, events and legacies that truly define us as individuals. Plans are then designed and implemented to deliver those priorities that are truly important.

It is this Life-Based approach to planning that defines the practice philosophy of Financial Dynamics.

This commentary is but one example of that lifestyle-focused, broad-based and multi-disciplinary approach to Financial Planning that we provide to our clients. Contact us for insight on how we can add value to your planning process. We look forward to the conversation.