FPA FINANCIAL PLANNING ASSOCIATION | FINANCIAL PLANNING PERSPECTIVES

Transferring Assets to a 529 Plan

Description:
This article examines how Investors with certain types of college savings accounts may be able to transfer assets to a 529 plan tax free.

Synopsis:
Americans who want to take full advantage of 529 college savings plans may have the option of transferring assets from other types of college accounts into a 529 plan without triggering taxes or penalties. For example, assets in Coverdell Education Savings Accounts (formerly called Education IRAs) and so-called UGMA/UTMA accounts may be "rolled over" to a 529 plan tax free. The interest earned by some U.S. savings bonds may also be contributed to a 529 plan tax free. Of course, there are IRS rules and potential considerations to evaluate with each strategy. For example, ownership questions could arise if assets are moved from an account owned by a child to an account owned by a parent. As a result, some 529 plans may not allow parents to change beneficiaries after assets have been transferred from another type of account.

Body:

By now most Americans who are saving and investing to pay for college costs have probably heard that so-called 529 college savings plans allow tax-free distributions for qualified education expenses, potentially making them even more attractive and effective than in the past, when they were only tax deferred. Add that tax benefit to other benefits of 529 plans, including high contribution limits, and many families may want to consider taking advantage of the plans.

But don't despair if you have already committed college-earmarked assets to another type of financial vehicle, such as a Coverdell Education Savings Account (formerly Education IRA) or a custodial account for a minor beneficiary. You may be able to transfer assets from either type of account into a 529 plan without triggering taxes or penalties. In addition, the proceeds from the redemption of certain types of U.S. savings bonds can also be transferred to a 529 plan tax free, as a result of the Treasury Department's "Education Bond Program."

Making the Move From a Coverdell

The IRS makes clear in Publication 970, *Tax Benefits for Higher Education*, that amounts transferred from a Coverdell account to a "qualified tuition program" (IRS lingo for a 529 plan) are viewed as qualified education expenses and are therefore tax free -- as long as the amount of the withdrawal is not more than the designated beneficiary's qualified education expenses.

There are several reasons a college saver may want to take this course of action. For example, to consolidate college assets into a single account with a more generous contribution limit. Whereas Coverdell accounts limit contributions to just $2,000 per beneficiary per year, 529 plans typically allow much higher lifetime contribution limits -- in excess of $200,000 per beneficiary in many states. And unlike Coverdells, 529 plans generally do not impose income limits that restrict the ability of higher-income taxpayers to contribute.

As you take other variables into account, keep in mind that Coverdells and 529 plans are still relatively new, so the legal and procedural precedents for specific strategies may not be well established yet. For example, there is the question of the ownership and control of any money that is transferred from a Coverdell to a 529 plan. By declaring in Publication 970 that "the designated beneficiary of a Coverdell can take withdrawals at any time," the IRS effectively states that the funds in a Coverdell are owned by the beneficiary. If those assets were moved to a 529 plan owned by a parent, however, it could be construed as a transfer of ownership from the beneficiary to the parent. In theory, at least, that could raise legal issues down the road if the parent eventually uses the money for personal reasons or changes the beneficiary of the 529 plan.

It's also important to remember that Coverdells can be used to pay for primary or secondary school costs, whereas 529 plans are limited to college expenses. Consequently, you might want to contribute to a Coverdell and a 529 plan if you need to pay for a primary or secondary education in addition to college.

Relocating UGMA/UTMA Assets

Many 529 plans also accept rollovers from custodial accounts established for minor beneficiaries, such as those created under the provisions of the Uniform Gifts/Uniform Transfers to Minors Act (UGMA/UTMA). Keep in mind, though, that the money in an UGMA/UTMA account belongs to the minor, so any subsequent withdrawals of those assets after a transfer to a 529 plan may only be used for that minor.

Therefore, you are generally prohibited from changing the beneficiary of a 529 plan after assets from that beneficiary's UGMA/UTMA account have been transferred to the 529 plan. Also, the minor will gain full control of the UGMA/UTMA money at age 18 or 21 (depending on the state), which is not normally the case with 529 plans. Keep in mind, too, that contributions to 529 plans must be in cash. As a result, UGMA/UTMA assets would first need to be liquidated, with any capital gains being taxable to the minor.

Back to Basics: An Overview of 529 Plans, Coverdell Education Savings Accounts, and Custodial Accounts

As you begin your search for tax-efficient strategies to pay for college costs, keep in mind that 529 plans, Coverdell Education Savings Accounts, and UGMA/UTMA accounts each offer unique benefits. It's critical that you understand all of them before making a final decision.

Section 529 college savings plans are named after the section of IRS code that created them. They are college- or state-sponsored, tax-advantaged plans that allow individuals to invest in portfolios of stocks, bonds, and cash equivalents. Contribution limits for 529 plans vary from state to state. Distributions made to pay qualified education expenses are tax free. Prepaid tuition plans also fall under Section 529, but for the purposes of this article, the phrase 529 plan refers only to a college savings plan.

Coverdell Education Savings Accounts (formerly known as Education IRAs) allow tax-free earnings on nondeductible contributions of up to $2,000 per year, per student. Coverdells can generally hold a variety of investments. They can only be established for a child younger than 18, and the money must be distributed for educational costs before the beneficiary turns 30. Income limits apply: Single filers with modified adjusted gross incomes (MAGI) of more than $110,000 and joint filers with MAGI in excess of $220,000 are not eligible. Qualified withdrawals may be used to fund a primary, secondary, or college education.

An UGMA/UTMA custodial account allows you to establish a savings or investment account in a child's name, with one adult named as custodian. Each parent can contribute up to $14,000 in 2016 without triggering mandatory filing of IRS Gift Tax Form 706 and possible payment of gift taxes. With an UGMA/UTMA account, the first $1,050 per year of unearned income is tax free. For children under 19 (and for children under 24 who are full-time students and whose earned income does not exceed half of the annual expenses for their support), the next $1,050 is taxed at the child's rate. Beyond $2,100, the income is taxed at the parent's or child's rate, whichever is higher.

A Better Bond Strategy?

The third option you may have for a transfer involves cashing in qualified U.S. savings bonds and contributing the proceeds to a 529 plan, in accordance with the guidelines established by the IRS and the Treasury Department's "Education Bond Program." This strategy allows you to avoid the normal taxation of interest earned on U.S. savings bonds.

Only Series EE bonds issued since 1990 and Series I bonds can be used in this manner. To qualify, you need to have been at least 24 years old on the first day of the month in which you purchased the bonds. If the bonds are to be used for your child's education, they must be registered in your name and/or your spouse's name. (The child can be listed as a beneficiary of the bonds, but not as owner or co-owner.) If the bonds are to be used for your own education, they must be registered in your name. If you are married, you must file a joint tax return to reap the benefits of this program.

Work With a Pro

Which 529 transfer strategy makes the most sense in light of your unique situation? Will there be tax benefits or consequences? Before you decide, you should speak with financial and tax advisors who have the knowledge and experience to help assess your entire range of options.