

Can you transfer a custodial account to a section 529 plan?

Transfers to Section 529 Plans

People who have set up custodial accounts under the Uniform Transfers to Minors Act ("UTMA") sometimes wonder whether they're permitted to transfer a custodial account to a section 529 college savings plan. Possible benefits:

- ◆ Greater control
- ◆ Better treatment under financial aid formula
- ◆ Tax advantages
- ◆ On this page we discuss whether these transfers are permitted, and whether these advantages really exist.

Section 529 Savings Plans

Section 529 plans are sponsored by individual states and are rapidly growing in popularity. They should become even more popular now that earnings of these plans are permitted to be withdrawn tax-free if used for qualified higher education expenses beginning in 2002. Some of the features of these plans relevant to this discussion are as follows:

The investment choice for the account is made when you set it up and can be changed only once per year except when you change beneficiaries or move the money to a different state's plan.

Income generated by the 529 savings account is not taxable until the money is withdrawn. Beginning in 2002, if the money is withdrawn for qualifying higher education expenses, the income is tax-free. The owner of the account can change the beneficiary to another member of the beneficiary's family (handy if one child decides not to go to college).

The owner of the account can demand a refund of the account, but will incur tax and a penalty on the earnings.

The account can continue under the control of the parent even after the child reaches age 21. The account is treated as an asset of the parent, not the student, for purposes of the student financial aid form. This treatment is advantageous because the aid formula expects a smaller contribution from parental assets than from assets owned by a student.

Custodial Accounts

Here is how a custodial account differs on the points listed above:

The custodian is free to change investments at any time without penalty (other than charges imposed by the financial institution, such as an early withdrawal penalty). A change in investments may result in income that would be taxable at that time, however.

Income generated in a custodial account is currently taxable to the child who owns the account.

The custodian (or donor) can't change the owner of the account.

The custodian (or donor) can't take the money back.

Control of the account passes to the child at age 18 or 21 (differs according to state law).

The custodial account is an asset of the child for purposes of the student financial aid formula.

Is a Transfer Permitted?

There's no definitive ruling on whether you're allowed to transfer assets from a custodial account to a section 529 account. In fact, there's no central authority that could issue such a ruling. Section 529 plans must operate within certain parameters set forth in the tax law, but most of their rules are established by the individual states. Likewise, custodial accounts are creatures of state law. The IRS may tell you the tax consequences of using them in different ways, but they have no authority to tell you what you may or may not do with these accounts. The following comments are based on analysis of the rules for custodial accounts as set forth in the Uniform Act together with general observations about the way section 529 plans work. The rules for both the Uniform Act and section 529 plans may differ in your state, although differences for this purpose are usually a matter of detail.

Acceptance by the section 529 plan.

The first thing you need to know is whether the section 529 plan you want to use will accept the transfer and under what terms. I understand that some section 529 plans have not yet decided that they can accept these transfers, or have decided that they cannot. Others accept transfers but impose restrictions on them. One restriction I have heard mentioned is that you aren't permitted to change the beneficiary, as is normally permitted in a section 529 plan. As explained below, changing the beneficiary would violate the Uniform Act, so this isn't a restriction that will cramp your style unless you were planning to do something improper. If your plan won't accept the transfer or imposes conditions you find unacceptable, you either have to deal with a different plan or abandon the idea.

Uniform Act provisions.

Having found a section 529 plan that will accept the transfer, you still have to consider how the Uniform Transfers to Minors Act applies. Under the Uniform Act, the custodian's responsibility to preserve the assets for the benefit of the child doesn't terminate when cash or assets are withdrawn from a custodial account. If custodial assets are invested in a 529 account, those assets continue to be assets owned by the child and subject to the protections afforded by the Uniform Act. If permitted by the 529 plan, the account should be designated as a custodial account, with the owner being shown as "[parent's name], as custodian for [minor's name]." Even if the 529 plan doesn't accept such a designation on the account, the Uniform Act continues to apply. The custodianship doesn't terminate until the money is transferred to the child or expended for the child's benefit.

Consequences of the Transfer

The account has been established with assets belonging to the child and subject to the protections afforded by the Uniform Transfers to Minors Act. As a result, the following appear to be true:

It would be improper for the parent to change the beneficiary of the account even if the rules of the 529 plan permit such a change.

It would be improper for the parent to take a refund from the account except for the purpose of making an expenditure for the benefit of the child that is permitted under the Uniform Act.

Control of the account should pass to the child at the same age control would have passed if the assets had remained in the (regular) custodial account.

Although a "normal" 529 savings account is treated as an asset of the parent for purposes of the financial aid form, it would appear to be proper to treat a 529 savings account established with custodial assets as an asset of the child when filling out these forms.

These consequences may defeat one or more of the goals you have in transferring assets from a custodial account to a 529 account. As a purely legal matter, this transfer does not enhance or extend the parent's control over the money. As a practical matter, moving assets from a custodial account to a 529 account may create a barrier — at least an emotional one — against use of the assets for something other than college. Parents will have to judge whether this limited benefit justifies the change.

Tax Consequences

You can't contribute assets other than cash to a 529 account. That means any assets in the custodial account would have to be sold before you can make a transfer to a 529 account. If those assets have grown in value, the sale will result in gain that's taxable on the child's tax return.

After the switch, the earnings of the account will grow tax-free. That's an advantage if the earnings in the custodial account were large enough to result in tax on the minor. Generally minors can receive a limited amount of investment earnings (up to \$750 in 2001) without incurring tax unless their other earnings consume their standard deduction.

Earnings in the 529 account will be tax-free at withdrawal (beginning in 2002) if the money is used for qualifying higher education expenses. If money is used for other purposes, though, the earnings will be taxable and generally subject to a 10% penalty tax as well. You can look at this tax and penalty as an advantage if it discourages your child from using the account for a purpose other than education, but potentially this tax result can be a disadvantage, particularly if you can foresee a possible future in which you agree with your child that the money can be used for a purpose other than college expenses.

Summary

Transferring custodial assets to a 529 account doesn't solve the problems associated with ownership of those assets by the child. The change may encourage the child to use the assets for education, but doesn't prevent other use — at least if you plan to comply with the terms of the Uniform Transfers to Minors Act.

The transfer has other consequences. You lose a considerable amount of investment flexibility because of rules that apply to 529 accounts. You gain favorable tax treatment if the account is used for qualifying higher education expenses, but get unfavorable tax treatment if the account is used for any other purpose. Meanwhile you may incur tax cost as a result of making the transfer.

For most people, a 529 account is a better choice for college savings than a custodial account under the Uniform Transfers to Minors Act. That doesn't mean it's necessarily a good idea to switch assets to a 529 account once a custodial account has been created. Overall this is a close question, and the wisdom of making the change will depend on your own situation and preferences. Some people will find it makes more sense to leave existing money in the custodial account and place any additional savings in a 529 account or education IRA.*

* The education IRA has been renamed the Coverdell education savings account but we'll continue to use the old terminology until the public becomes familiar with the new name.

by Kaye Thomas
December 19, 2001

A publication of Fairmark Press Inc.
© Copyright 1997-2002, Kaye A. Thomas
All rights reserved