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College Funding Options - Custodial Accounts, Coverdell Education Savings Accounts and Qualified Tuition Programs

For decades, parents have used custodial accounts to transfer funds to their minor children to help build assets for college costs. However, the 2001 tax law has enhanced the tax benefits of other types of asset ownership that should be considered. Coverdell Education Savings Accounts (Education IRAs) and Qualified Tuition Programs (Section 529 Plans) have become very attractive.

Custodial Accounts

Using a Uniform Gifts to Minors Act (UGMA) or Uniform Transfer to Minor Act (UTMA) account is an easy and legal way to transfer the ownership of assets to a child. With a UGMA or UTMA account, the parent creates a custodial account on behalf of the minor child. Assets are transferred into the account and the custodian, usually a parent, manages the account until the child reaches legal age. At that point, the child can do whatever he or she wishes with the assets.

Transfers to these accounts are irrevocable. You cannot change your mind later and take the assets back. Your child becomes the owner when you make the transfer and on reaching the age of majority (18 or 21 in most states) the child can do whatever they wish with the money.

Transfers into a custodial account are just like any other gift. For 2019, you can make annual gifts up to $15,000 in cash, securities or other property to anyone without owing any federal gift tax and without filing a gift tax return.

If you are married, gifts can be considered to be half from you and half from your spouse. This enables transfers up to $30,000 to be made. However, a simple gift tax return may be required if you use this gift-splitting technique. The annual $15,000 exclusion applies to each person receiving the gift.

When the assets become the child's, any income the assets produce is taxed to the child. There are special tax rules that apply to children under the age of 18, 18 year olds with earned income less than half of their support, and 19 to 23 year old students with earned income less than half of their support. These rules are commonly called the “Kiddie” tax.

The Tax Cuts and Jobs Act of 2017 made substantial changes to the Kiddie tax and you may want to consult your tax advisor to understand how the new rules may apply to your child.

Coverdell Education Savings Accounts (Education IRAs)
Education IRAs provide parents and others the opportunity to save for a child's education expenses in a tax advantaged account. There is a $2000 limit on annual contributions and there is an income limit for those making contributions. Married couples filing a joint tax return can make a full $2000 contribution if their adjusted gross income is less than $190,000; they can make a partial contribution if their AGI is between $190,000 and $220,000; and no contribution if their income is above $220,000. For single taxpayers, the limit is one half of those amounts.

Earnings within the account are tax deferred and withdrawals are not subject to tax if they are used for qualified education expenses. The new law expanded this definition to include expenses for elementary and high school expenses. Withdrawals not used for qualified education expenses are subject to regular income tax and a 10% penalty. Withdrawals must also be completed before the child reaches age 30.

Coverdell Education Savings Accounts function like IRA accounts and are available from most banks, credit unions, brokerage firms and mutual fund companies. Investment options vary depending on the firm. Usually there is considerable flexibility with "self-directed" type accounts.

Qualified Tuition (Section 529) Plans
These college savings plans are now offered by over 40 states and were also enhanced by the 2001 Tax Law. While the plans are offered by the state, there is no restriction on where the child may attend college utilizing the funds. One potential drawback is that there are usually limited investment options. It makes sense to look at several states' programs to find one that offers the investment choices you desire.

With a Section 529 Plan, there are no income limits on the donors and contributions of up to $15,000 per year (for 2019) can be made. In addition, there are special provisions to allow a "front-end loading" of up to five years of contributions to be made without gift taxes.

Summary
Custodial accounts offer the greatest flexibility in terms of how the money is ultimately used. However, they lack the tax benefits of the other programs.

Coverdell Education Savings Accounts offer the greatest flexibility in terms of how the money is used for education. However, there are limits on the income of the donors and the annual contribution limit is $2000 and reverts to $500 unless Congress takes action.

Section 529 Plans offer the highest contribution limits without income limits on the donors. However, in many cases the investment options may be limited.

As with most financial decisions, you must consider what you are trying to accomplish. Be mindful of the tax implications and choose the one (or combination) that best fits your situation.