



# “ On T h e M o n e y R e p o r t ”

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## **Converting Custodial Accounts to 529s —The Hidden Risks**

**The Tax Relief Act of 2001 made the already-popular 529 college savings plans even sweeter—so sweet, in fact, that many higher-income parents with custodial accounts are rushing to transfer their funds to 529 plans. But beware: conversion often doesn't make sense**

We've all heard about the benefits of college savings plans versus custodial accounts. College savings plans allow parents (or other funders) to retain control of assets; they allow funders to change beneficiaries; and, because they're considered parental assets, they may have less impact on student aid than custodial accounts. And then there are the tax advantages. While custodial accounts modestly reduce the tax bite on earnings, earnings in 529 plans grow entirely free of tax—and remain so as long as they're used for qualified education expenses. Some states also allow tax deductions for contributions made to in-state 529 plans.

### **Converting? Not so fast**

But before you convert your child's custodial account into a college savings plan, be aware that custodial accounts have advantages of their own. For starters, a custodial account allows the parent to retain complete control over the investment choices. The parent can also use the account's funds for expenses other than the child's college tuition—paying for her orthodontia, for example, or for her music lessons. And when the child assumes control of the account at age

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18 or 21 (depending on the state), she'll incur no tax penalty if she elects to use the money to cover costs other than education expenses.

Converting assets into a college savings plan can also result in a number of potential problems. First off, converting a custodial account into a 529 plan does not change ownership of the assets. Gifts made to a custodial account are irrevocable; your child continues to own these assets even after they're transferred to a 529 plan. In fact, these funds are typically moved into what are known as 529 custodial accounts, and are not commingled with assets invested in a regular 529 plan. That means that if the custodial child decides *not* to attend college, you won't have the option of changing account beneficiaries. If, when the child takes control of the money at the age of majority, she chooses to spend the money on something other than college, she's within her legal rights—but she'll face a 10% penalty, plus ordinary income taxes, on her earnings.

If your child does go to college, moreover, she won't gain much in the way of financial-aid benefits should you convert. The custodial 529 account will be treated as a parental asset, just like a regular 529 plan; when the funds are actually distributed, however, they are treated as student income, which counts more heavily against financial aid.

As far as the mechanics of conversion go, remember that you can't transfer the assets from a custodial account directly into a 529 custodial account; 529 accounts accept only cash, so you'll have to first sell stocks, bonds and other noncash assets in the custodial account and pay any taxes due on the gains. In addition, not all state plans accept custodial account conversions. If your state does not, you can join an out-of-state plan that does, but doing so would cause you to lose any state tax breaks.

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At this point, you may be asking yourself: "Does it ever make sense to convert?" In limited situations, yes, but you'll want to review the numbers carefully. And remember that converting makes no sense if you intend to use the assets for purposes other than your child's college. Conversion also tends to make less sense if the child is older, because you probably won't benefit enough from the better tax breaks in the 529 to offset any substantial capital-gains taxes incurred from the conversion.

## **Alternatives to conversion**

There are also other options to consider before converting. The simplest is to stop funding the custodial account and start funding a regular college savings plan. This works especially well if the custodial account is small.

Another strategy is to spend the money from the custodial account on nonessential needs for the child. Parents aren't allowed to spend the money on necessities such as clothing and food, but they can use the cash to cover the costs of private school tuition, computers, and so forth. You could then contribute the amount of these expenditures—which you would otherwise have paid for out of household income—to a regular 529 plan.

*Steve*

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