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How does a 529 plan compare with an UGMA/UTMA custodial account in my child's name?

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## How does a 529 plan compare with an UGMA/UTMA custodial account in my child's name?

### Answer:

There are several issues to consider here. One advantage of the 529 plan is your ability to retain control. If you transfer assets to a custodial account in your child's name, your child becomes the legal owner of the account upon reaching majority age (18 or 21, depending on the state). Your child can then use the assets as he or she pleases, even if that means buying a new Ferrari instead of funding college costs. A 529 account gives you much more control, assuming you name yourself as owner and your child as beneficiary. As the account owner, you decide when the money will be withdrawn and for what purpose.

Taxes are another important issue. Withdrawals from a 529 plan that are used to pay qualified education expenses are completely free from federal income tax. Your state may offer tax breaks for 529 plans, as well. In contrast, the earnings on assets in a custodial account are taxed to your child every year (even if no withdrawals are made) and are subject to special rules commonly referred to as the "kiddie tax." Children subject to the kiddie tax are generally taxed at their parents' tax rate on any unearned income over a certain amount. This amount is currently \$2,000 (the first \$1,000 is tax free and the next \$1,000 is taxed at the child's rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support.

This doesn't mean that there are no advantages to saving with a custodial account in your child's name. Custodial accounts offer more flexibility in accessing the funds. For example, if you need money to pay your child's medical bills, you can tap the custodial account without penalty. By contrast, the earnings portion of a 529 plan withdrawal will be taxed and penalized if the money isn't used for education.

Another advantage of custodial accounts is that you can fully control the underlying investments--you can be as aggressive as you want and you can change investments as often as you want. With 529 plans, however, you have only limited control over your investments. With a prepaid tuition plan, you have no say in how your money is invested (though you are generally guaranteed a certain rate of return or a certain amount of future tuition costs). With a college savings plan, you can generally select an investment portfolio at the time you join a plan (though never the portfolio's underlying investments). Beyond that, plans differ on the investment flexibility they give you. Some plans may let you direct future contributions to a new investment portfolio. States may also let you change the investment option for your existing contributions once per calendar year or when you change the beneficiary. Check with your college savings plan for more details.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.

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