529 COLLEGE SAVINGS PLANS AND UTMA ACCOUNTS: AN OVERVIEW

Founded in 1964, First Manhattan is an independently owned and operated investment advisory and wealth planning firm with more than $20 billion in fee-paying assets under management. First Manhattan strives to deliver long-term value through an investment approach aligned with clients' goals and driven by in-house, proprietary research.

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Depending upon your individual circumstances, a 529 plan or an UTMA account could be a valuable college savings and/or gifting tool for a minor. Below, we provide an overview of both.

We are available to answer your questions on this topic and to help you determine if a 529 plan, UTMA account, or another option may work best for you.

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529 Plans: An Overview

A 529 plan (legally known as a "qualified tuition plan") is a tax-advantaged program used to fund a beneficiary's future education costs. There are two types of 529 plans: a prepaid tuition plan and a savings plan. This white paper discusses the latter.

To avoid incurring a tax penalty, the funds in a 529 plan must be used toward what are known as "qualified education expenses." These include:

- Tuition and fees
- Room and board
- Meal plans
- Books and supplies
- Computer technology, equipment, and software
- Student loans (up to a lifetime limit of $10,000)

Benefits of 529 Plans

Offer Multiple Tax Advantages

A significant advantage of a 529 plan is that contributions grow tax-free. Distributions are also tax-free if the funds are used toward qualified education expenses. While there are no federal tax deductions for contributions made to a 529 plan, many states offer state tax deductions. For example, New York state taxpayers who contribute to a 529 plan may be eligible to deduct up to $10,000 on their state tax return. We encourage you to consult with your tax advisor regarding your particular situation.

Provide Lump-Sum Gifting Advantages

In most cases, annual gifts that exceed $16,000 (scheduled to increase to $17,000 in 2023) are subject to gift tax rules. However, with a 529 plan, individuals may contribute up to five years' worth of gifts, or $80,000 ($160,000 for married couples in 2022), in a single year without having it count toward the lifetime exemption ($12.06 million for 2022). There are also lifetime limits on contributions to 529 plans, but each state has its own limit.

Allow for Beneficiary Changes

If the original beneficiary of a 529 plan doesn't use some (or all) of the funds, the plan owner may transfer the remaining funds to a different beneficiary without incurring any penalty or cost.

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Are Not Limited to Higher Education Costs

While 529 plans are most often used to pay for costs associated with higher education, they may also be used toward tuition for vocational or trade school. In addition, the 2017 Tax Cuts and Jobs Act expanded the definition of qualified education expenses to include the ability to use up to $10,000 toward annual tuition for K-12 public, private, and religious schooling per beneficiary. (Note: eligibility to do so will vary by state, as not all states recognize K-12 schooling as a qualified expense).

529 Plans: What to Consider

Must Be Used for Qualified Education Expenses

If the funds in a 529 plan are not used for qualified education expenses, withdrawals may be subject to federal and state income taxes as well as a 10% penalty on the plan's earnings.

Have Tax and Investment Benefits That Vary by State

All states and the District of Columbia sponsor at least one 529 plan, but individuals are not required to open a plan in their state of residence. The tax and investment benefits of each state-sponsored 529 plan can vary, so it may be worth considering other states' offerings. Each state that offers a 529 savings plan will limit the maximum account balance for the same designated beneficiary. However, although that maximum account balance varies from state to state, it is generally a high amount. A list of the various plan offerings can be viewed here.

Have Fees and Expenses

As is the case with mutual funds and ETFs, there are expense ratios on the funds within the plan. However, these are comparable to index and passive expense ratios in the market.

UTMA Accounts: An Overview

Established by each state's Uniform Transfers to Minors Act, an UTMA is a type of custodial account that allows individuals to gift assets to minors without a guardian or trustee in place. A custodian is appointed to manage the assets, which are then turned over to a minor when he or she reaches a certain age of majority. This age can vary both by state and type of custodial account. For example, in New York the age of majority for an UTMA account is 21 unless the age of 18 is specified at the time of the transfer.

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Benefits of UTMA Accounts

Provide Significant Flexibility

Gift type: A donor can gift both cash and physical assets, including real estate, fine art, patents, and royalties.

Investment options: While a 529 plan is limited by the plan sponsor's predetermined selections, an UTMA account has both public and private investment options.

Use cases: There are no limitations to what an UTMA account can be used for (as long as it benefits the minor). This can make it an attractive option for donors looking to help a minor pay for expenses not related to education, such as a first car or a future home. If the minor later chooses to use an UTMA account for educational expenses, the funds can be moved into a 529 plan to leverage its education-related tax advantages. (Note, however, that funds from a 529 plan cannot be moved into an UTMA account).

Offer Gift Tax Benefits

Just like 529 plans, annual contributions made to UTMA accounts of up to $16,000 are not subject to the gift tax. If a donor is interested in gifting more than these amounts, transferring the funds to another type of account may be possible.

UTMA Accounts: What to Consider

Offer Fewer Tax Advantages

UTMA accounts can trigger the kiddie tax rule, which taxes a child's investments and other unearned income. According to 2022 rules, while the first $1,150 of unearned income will not be taxed, the next $1,150 is taxed at the child's rate. Unearned income of $2,300 is taxed at the parents' rate, and above $2,300 requires a separate tax return.

Limit Control Until Age of Majority

Once a minor reaches his or her state's age of majority, the donor no longer has control over the assets in the UTMA account. The minor is free to use the assets however he or she wishes, which may go against the donor's intentions.

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Can Affect Financial Aid Eligibility

If a minor plans to apply for financial aid by filling out the Free Application for Federal Student Aid (FAFSA) form, UTMA accounts are considered student assets, which are weighted much more heavily when calculating eligibility. 529 plan assets typically fall under the parental asset category.

At-A-Glance: 529s and UTMAs

	529s	UTMAs
Use case?	Qualified education expenses	May be used for any purpose
Control?	Custodian maintains control	Minor gains control at age of majority
Contribution limits?	Generous limits exist	None
Tax benefits?	Yes	Limited
Investment Options?	Limited	Flexible
Transferable among beneficiaries?	Yes	No
Negative impact on financial aid eligibility?	Lesser	Greater

The best way to determine if a 529 plan or an UTMA account is the right college savings and/or gifting tool for you is to speak with your First Manhattan team. Please contact us if we can be helpful to you in any way.

An investor should consider, before investing, whether the investor's or designated beneficiary's home state offers any state tax or other state benefits such as financial aid, scholarship funds, and protection from creditors that are only available for investments in such state's qualified tuition program.

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