

# Looking For That Ideal Holiday Gift For The Kids Or Grandkids?

Cal Brown, CFP

*If you are a parent or grandparent who is concerned about higher education, the Tax Cut of 2001 may have created a wonderful gift opportunity.*

**I**n fact, one of the new provisions is unique in that you can irrevocably give a fairly large amount to a child, get it out of your estate, but later take it back if things don't work according to your desires. Is that possible? It never has been before, but it is now with the so-called Section 529 Plans!

Strange, but true. Although Section 529 Plans were not created by the Tax Cut of 2001, they were significantly improved by this legislation. How so? Read my lips: "No Taxes."

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What is a Section 529 Plan, you ask? It is one type of Qualified State Tuition Plan. The other category is the familiar Pre-Paid Tuition Plan. The Pre-Paid Tuition Plans are quite

limited in scope, in that the funds can only be used for tuition—not for room and board, books, transportation, or other expenses associated with college. In fact, tuition is less than half the cost at many institutions. Furthermore, with a Pre-Paid Tuition Plan there are significant penalties if a child does not attend college in the state that sponsors the plan.

Unlike a Pre-Paid Tuition Plan, which guarantees the in-state tuition when the child goes to college, a Section 529 Plan does not guarantee anything. In that respect, it is similar to a Roth IRA in that it is a tax-advantaged savings vehicle. You put money in and it grows (hopefully!), plus you get a tax benefit.

## Tax Break For The Holidays

What is the tax benefit, you ask? Well, there are several. There are gift and estate tax breaks as well as income tax benefits. Here is a snapshot of the tax provisions of Section 529 Plans:

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- 1) ESTATE AND GIFT TAX BENEFITS
  - a. May gift up to \$10,000 per year, per child
  - b. May front-end load the gifting for five years; i.e., put in a maximum of \$50,000 up front, if desired
  - c. The gift amount is a “completed gift” which means it is out of your estate
  - d. Yet, you control the account (that’s unique!)
  - e. If the child does not go to college, or if he/she matures in an unsatisfactory manner, you can transfer it to another child, or you may cash in the Section 529 Plan, pay ordinary income tax plus a 10% penalty on the gains, and deposit it in your investment account (at that point it would be back in your estate, of course)
- 2) INCOME TAX BENEFITS
  - a. The gift may be deductible on your State income tax return (not Federal). This is not available in all states, and may be limited to a certain dollar amount
  - b. All interest and dividend income as well as capital growth is tax-deferred
  - c. The cash comes out completely tax-free if used for college (technically: “qualified education expenses” which include tuition, room and board, books, etc.)
  - d. The account may be transferred to another relative, tax-free

If your head is spinning, give us a call and we’ll explain these tax benefits more fully.

So if you’d like to give a meaningful gift this Holiday Season, you might want to consider a nicely wrapped Section 529 Plan for that child or grandchild of yours.

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### Do Custodial Accounts Measure Up?

Unlike the traditional custodial accounts (UTMA or UGMA), the money in a Section 529 Plan does not legally belong to the child when he or she attains age 18. As mentioned above, you can actually take the money back from a Section 529 Plan. This is just not possible with a custodial account. In addition, if you die before the child reaches age 18, the money in a custodial account is includible in your gross estate.

Can you transfer money from a custodial account to a Section 529 Plan and get all the benefits? No. Although most (but not all) Section 529 plans will accept funds coming from an existing custodial account, any withdrawals from the account must be for the benefit of that minor only, even if it has been transferred into a Section 529 Plan. Why? Because these funds are owned by the minor under the custodial arrangement. You will not be able to make any beneficiary changes to the Section 529 account, and the minor will assume direct ownership of the account at the age of majority.

Thus, you cannot regain control of the money by transferring the custodial funds to a Section 529 Plan. Furthermore, you cannot transfer stocks or mutual funds “in kind” into a Section 529 Plan—it can only accept cash; therefore, any securities in the UTMA would first have to be sold and taxes paid by the minor. Once these transaction costs and taxes have been paid, the placement of UTMA funds in a Section 529 account can provide the tax benefits associated with Section 529 Plans.

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### How About A Pre-paid Gift?

Pre-paid tuition plans, even with their restrictions, are still a good idea for grandparent gifts. Why? Because regardless of whatever happens in the future to the family or with tuition increases, you can rest easy knowing that your grandchild’s college tuition will be paid for. As long as the student can find a place to live, he or she will be able to get a college education in the state. You

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should know that these pre-paid plans were also upgraded with the 2001 tax legislation—the proceeds are now tax-free as well. Most folks did not understand that under prior law the kids were going to get nailed with taxes on the gain.

But, as stated above, Pre-paid plans only go so far. The Section 529 Plans, although not guaranteed, can potentially provide so much more for your kids. First, they can pay for much more than just tuition. Second, they can earn a higher equity return (the Pre-paid plans assume basically a fixed-income level of return). Third, your grandkids can go to any college in any state.

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### Education IRA's Could Be The Ticket

What about Education IRA's (in 2002 they will be known as Education Savings Plans)? They're not bad, either. They, too, have been conferred with tax-free withdrawal status. In fact, the withdrawals allowed are even more liberal. Tax-free withdrawals can be made for elementary through high school private school tuition, as well as to buy uniforms, computers and even Internet access! However, the contributions are limited to \$2,000 per person after tax year 2001 (currently it is only \$500 per person). And there are income limitations as well: single taxpayers with Adjusted Gross Income (AGI) above \$95,000 need not apply, nor joint filers with AGI above \$190,000 (that's up from \$150,000 in 2001).

Can you take money back from an Education Savings Plan? Yes, again by paying ordinary income tax plus a 10% penalty on the gains. Is the amount contributed to an Education Savings Plan out of your estate? Yes.

So which is better, the Section 529 Plan or the Education Savings Plan? It boils down to two things: the size of your gift and your income. If you want to give more than \$2,000 per child or if your income exceeds the limits above, you cannot use the Education Savings

Plan and thus the Section 529 Plan would be the best option. However, if your gift will be \$2,000 or less and your income is under the limits, then the Education Savings Plan would be better. Why? More flexibility. Remember, the Education Savings Plan has more liberal withdrawal provisions. Also, you would have more investment control.

And that leads to the main problem with Section 529 Plans.

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### What's The Catch?

You probably had the idea from all the press that the Section 529 Plans are the best thing going, with no downside. Sorry, but there are a few problems and they relate to investment flexibility, control and complexity.

By law, in a Section 529 Plan you cannot dictate the investments. The state controls the particular investment vehicles. You can select from aggressive, moderate, or conservative allocations but you cannot pick the mutual funds or stocks and bonds that make up those allocations. You cannot even pick the fund family, unless you select a state that uses a particular mutual fund family. But if you use a state that is not your resident state, you will lose the state income tax deduction, if applicable.

In some states, the asset allocation will automatically become more conservative (i.e., more fixed income, less equities) as the child gets older. In other states, you can keep the allocation constant. *Some states do not allow any equity component.*

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### Summary

Now you are getting an understanding of the complexity of these plans. Which state has the best plan? There is not an easy answer to that question. The first step would be to consider how important the state income tax deduction is to you. If it is important, and your resident state's plan is not that bad, then

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by all means use it. If that deduction is not critical, then you should look at the following details of the various states' plans: fees and expenses of the funds, the Investment Manager, and the investment options available. The investment options available would not only be the number of choices, but also whether the allocation automatically gets more conservative over time or if you can keep the allocation constant. These are complicated matters and beyond the scope of this article.

However, with an Education Savings Plan, you are in complete control of selecting the investment vehicles. For smaller gifts and incomes, this is another point favoring the Education Savings Plans over the Section 529 Plans.

Even with all these complicated factors, a gift of a future college education could be the ideal holiday gift this year. Be careful of some provisions which do not go into effect until 2002, such as the higher contribution limit on the Education Savings Plan, as well as tax-free withdrawals from all plans. If you do not feel that you can make the appropriate decision as to the vehicle to use, whether Section 529 Plan, Education Savings Plan, or Pre-paid Tuition Plan, we can help you.

One final note which may be of interest: A company in New England, UPromise, has developed another way for parent or grandparents to help save for college using a Section 529 Plan. It works like this: You make normal purchases of retail items such as gasoline, groceries, etc., and the retailer donates a portion of the profits to a Section 529 Plan for your child. Major companies such as ExxonMobil, McDonald's, ToysRUs, Coca-Cola, and General Motors are currently participants. You can also get a rebate from financing or refinancing a home mortgage through Countrywide. The various retailers will have different formulas as to the contribution amount, and you have to register your credit cards with them.

While this is a positive and "painless" way to save, there are potential downsides: Online registration of credit cards may be a security concern for you. Also, you might be

able to purchase the same item from another retailer for a lower price, and you could deposit those savings directly into your Section 529 Plan. Recognize this is a form of "forced savings," which may be appropriate for some but not for others. This program is best suited for those who purchase products from these retailers anyway, even if this bonus did not exist.

The Monitor Group, Inc. does not endorse this company, does not receive any remuneration of any kind from UPromise and makes no warranty as to the viability of the program. Nevertheless, we think it is an interesting and potentially beneficial concept. Check into the details at [www.upromise.com](http://www.upromise.com).

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