

Custodial Accounts

Custodial accounts—Uniform Gift to Minors Act (UGMA) accounts or Uniform Transfer to Minors Act (UTMA) accounts—are another tax-advantaged way to save for college. A parent, grandparent or other adult is custodian for the account and makes all the investment decisions until the child for whom the account was opened reaches the age of majority. UGMA accounts are limited to money and securities. UTMA accounts can hold other types of property. You can set up these accounts at almost any brokerage firm, mutual-fund company or other financial institution.

Advantages

For children younger than 18, the first \$850 of unearned income is tax-free. The next \$850 is taxed at the child's federal tax rate. Any earnings over \$1,700 are taxed at the custodian's federal tax rate.

As with ESAs, your investing options are virtually limitless. Nor are there any contribution or income limitations. In addition, withdrawals can be used for any purpose, not just qualified education expenses, without penalty.

Disadvantages

When your child reaches the age of majority—18 to 25 depending on the state in which you live—he or she takes control of the account and can use the money in the account for anything. Because you lose control over how the money may be spent, some parents and grandparents may not like this option. Another potential disadvantage is that because the account is considered the child's asset, you can't switch beneficiaries. So if your child decides not to go to college or gets a scholarship, you can't switch the money to a brother, sister, or other family member.

Tax-Free Transfer to a 529 Plan. You now can transfer funds from a custodial account to a 529 plan if the plan accepts such transfers. However, you must liquidate any investments you have made in a custodial account because you can only transfer cash and pay taxes, if any, on any gains. Another problem with transferring custodial account funds is that the money is the child's asset, not yours, so you cannot transfer the 529 plan to another beneficiary. There also may be other restrictions and limitations.