CURTAILING A CHILD'S ACCESS TO CUSTODIAL ACCOUNTS TO AVOID A 21-YEAR-OLD MILLIONAIRE

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Far too many parents are lured by the simplicity of the Uniform Transfers to Minors Act, and use custodial accounts instead of inter vivos trusts to hold assets for their children. Once these accounts are in place and the assets have significantly appreciated (relatively common in today's stock market), is there anything the custodian can do to keep a huge amount of capital out of the hands of one too unsophisticated to handle it properly?

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Many parents believe they should place at least some of their wealth in their child's name. They think this approach will save taxes and provide a ready reserve for their child's college and professional education. As a means to this end, these parents often establish custodial accounts under the Uniform Transfers to Minors Act (UTMA) or its predecessor, the Uniform Gifts to Minors Act (UGMA). These accounts are also used to hold assets given to minors by third parties (e.g., grandparents, other relatives, and family friends).

All too often, however, parents do not realize the consequences of using custodial accounts. In particular, they are usually surprised to discover that once their child reaches a certain age (in most instances, 21) the custodian *must* relinquish control and turn over the custodial account assets to the child. This is true even if the parents have serious misgivings as to whether the child has the financial acumen and responsibility to handle what may be a significant amount of wealth that could include cash, real estate, and stock.

Some choices are available to parents who have second thoughts regarding the pending enrichment of their child. While none of these may prove entirely satisfactory, use of these techniques may be able to delay the day of reckoning.

THE UNIFORM ACTS

In general, minors do not have the legal ability to contract. In the absence of remedial legislation, third parties entering into a commercial transaction with a custodian of a minor ran the risk of the minor subsequently disaffirming the transaction.[1] In 1956,[2] to facilitate the transfer of property held by custodians of minors, states began adopting UGMA. This legislative initiative authorized custodians of minors to enter into transactions that could not subsequently be disaffirmed by the minor for age-related reasons.

UGMA was somewhat narrow in scope, however. Only cash and securities were transferable under UGMA, and the only permissible transfers were gifts. To make it more useful, in 1983 UGMA was revised and renamed. Now, UTMA permits transfers of any variety of property (e.g., cash, securities, partnership interests, or real estate).[3] In addition, UTMA applies to virtually any type of transfer, including those made pursuant to a bequest, the exercise of a power of appointment, or beneficiary designation of nonprobate assets. The District of Columbia and almost every state[4] have adopted UTMA and it has, in most instances, supplanted UGMA as the vehicle of choice for transferring property to minors.

A salient feature of UTMA is its simplicity. A party making a transfer pursuant to UTMA must merely refer to it to have the statutory scheme apply, including in-

defeasibly vesting legal title to the property in the minor.[5] Until the minor attains a specified age (as defined under state law), management of UTMA property is vested in a single custodian.[6] This custodian has the responsibility to invest the custodial property with "all rights, powers, and authority over custodial property that unmarried adults have over their own property."[7] When exercising this authority, the custodian must adhere to the "standard of care that would be observed by a prudent person dealing with the property of another."[8]

The custodian *must* relinquish control and turn over the custodial account assets to the child once the designated age is attained.

UTMA contains a mandatory distribution requirement that is usually tied to the age of majority in the state in which the custodial account is established.[9] The specifics of this requirement vary depending on enabling state law. Some states (e.g., Alaska, California and Nevada) even permit the age of mandatory distribution to extend beyond the age of majority (which is usually age 18 or 21) to age 25 as long as the specified age is designated when the custodianship is established.[10]

TAX AND NON-TAX IMPLICATIONS

Because assets held pursuant to UTMA are indefeasibly vested in the minor, the filing of a separate return for the custodial account is not required. Any custodial account income or losses must be reported directly on the minor's own tax return. For a minor under age 14, the Section 1(g) "kiddie tax" may apply: If the minor's unearned income exceeds a minimum threshold ($1,400 in 1999 and 2000), any excess is taxed at the parents' highest marginal rate, if that tax is higher than what the minor otherwise would pay. (The parents instead can include on their own income tax return the child's unearned income.)

Many parents are also drawn to the use of UTMA accounts on behalf of their child in anticipation of saving gift, estate, and generation-skipping transfer (GST) taxes. Transfers made to UTMA accounts usually qualify for the annual gift tax exclusion (currently, $10,000, but scheduled to be adjusted for inflation),[11] and, if to a grandchild, the equivalent GST exclusion applicable to nontaxable gifts.[12] Therefore, if the UTMA transfer does not exceed $10,000 (or $20,000 if a married donor's spouse agrees to split gifts), a gift tax return does not have to be filed. If, however, a parent makes an UTMA transfer that exceeds the annual gift tax exclusion or will vest in the minor after age 21 (e.g., in California at age 25[13]), the parent will have to file a gift tax return. The value of this transfer may absorb a portion or all of the parent's remaining applicable exclusion amount under Section 2010 (currently $675,000, but scheduled to increase in uneven increments to $1 million in 2006) or, if the remaining applicable exclusion amount is insufficient, the parent may have to pay a gift tax.

Assets held in an UTMA account can appreciate in value outside of the parents' gross estates. Unfortunately, what many parents fail to realize is that if a parent serves as custodian of an UTMA account to which he or she has transferred assets, the Internal Revenue Code requires that should the parent die while the account is still in effect, the fair market value of the assets held in such UTMA account must be included in the parent's gross estate.[14] (To avoid estate tax inclusion, the noncontributing parent, a relative, or another third party should serve as account custodian.)[15]

UTMA accounts also may play a role in determining a child's qualification for educational financial aid. Many educational institutions include a child's assets as a factor. All too often, the custodial accounts are substantial enough to disqualify the child for the aid. This leaves parents in an awkward position: they may not be able to use the UTMA accounts to pay for their child's educational expenses,[16] yet they lack the economic wherewithal to meet these expenses themselves.

Finally, consideration must be given to the fact that UTMA generally requires that custodial accounts terminate when the beneficiary reaches a specified age. This requirement may prove to be a nonevent insofar as the minor is either fiscally responsible or

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[1] See, e.g., Dixon National Bank v. Neal, 125 N.E.2d 463 (Ill., 1955) (a contract of a minor is generally voidable at the election of the minor on attaining the age of majority).

[2] In 1955, the New York Stock Exchange initially sponsored the "Act Concerning Gifts of Securities to Minors." See the Uniform Gifts to Minors Act prefatory note, 8A U.L.A. 499 (1983).

[3] In UTMA jurisdictions, custodians generally may hold every conceivable legal or equitable interest in property of any kind, including real estate and tangible or intangible personal property. See Uniform Transfers to Minors Act, 8B U.L.A. 497 (1983), section 1 comment.

[4] South Carolina and Vermont have not adopted UTMA.

[5] UTMA section 11.

[6] *Id.*, section 10.

[7] *Id.*, section 13(a).

[8] *Id.*, sections 12(a) and (b).

[9] *Id.*, section 20(1).

[10] Alaska Stat. 13.46.195(e); Cal. Prob. Code 3920.5(d); Nev. Rev. Stat. 167.034(3)-(4).

[11] Section 2503(c); Rev. Rul. 59-357, 1959-2 CB 212.

[12] Section 2642(c)(1). For more on GST tax issues, see Harrington, McCaffrey, Plaine, and Schneider, "Trust Modification Prop. Regs. and Other Significant GST Tax Developments," 92 JTAX 212 (April 2000).

[13] See note 10, *supra*, and the accompanying text.

[14] Sections 2036 and 2038; Rev. Rul. 59-357, *supra* note 11. See, e.g., Prudowsky, 55 TC 890 (1971), *aff'd per cur.* 465 F.2d 62, 30 AFTR2d 72-5856 (CA-7, 1972). The decedent, prior to his death, made gifts to each of his three minor children of both stocks and cash pursuant to the Wisconsin UGMA, naming himself as custodian. The court held that where one who has a legal obligation of support transfers property to himself as custodian under UGMA, he thereby retains the power to apply the assets in satisfaction of his legal obligation, making the custodial property includable in the decedent's gross estate under Section 2036.

[15] Rev. Rul. 74-556, 1974-2 CB 300 (property given by a husband to minor children is not included in the wife's estate if she is the custodian, even though she consented to split the gift).

[16] See note 23, *infra*, and the accompanying text.

Practice Notes

Given the limited tax benefits and other implications associated with custodial accounts established under UTMA, parents of young children (and their advisors) should consider alternative arrangements. One such promising alternative is the establishment of a trust in lieu of a custodial account. Ordinarily, a trust provides many of the same advantages as a custodial account. For example, contributions to the trust will qualify for the annual exclusion assuming the child has a limited withdrawal right (i.e., a *Crummey* power) and the assets held in the trust will not be includable in the parents' gross estates. Furthermore, use of a trust does not suffer from the most serious custodial account deficit, namely, state law does not dictate when the disbursement of trust assets must be made; the grantor of the trust makes this choice.

Parents considering establishing a trust, however, must sacrifice the simplicity and administrative ease custodial accounts offer (e.g., a trust must file a separate income tax return and terms of these trusts generally require that the beneficiary be provided with written notice of their withdrawal rights).

Parents debating between the use of a trust vs. making UTMA gifts must weigh the advantages and disadvantages of each planning technique.

the custodial account does not hold assets of significant value. The prospect of the custodial account's ending may be unnerving to the parents, however, if the minor is a spendthrift, has a drug habit, or is a member of a cult, or simply if the custodial account holds assets of significant value.

The drawbacks of custodial accounts should obviously lead the parents of young children to consider alternative arrangements (e.g., establishment of an inter vivos trust; see "Practice Notes" on this page). But discussing what could have been will likely provide little solace to parents who have already established a custodial account under UTMA. Their concerns must therefore be addressed.

DEFERRING OUTRIGHT DISTRIBUTION

Many parents pride themselves on having hidden custodial accounts from their child's knowledge. For several years a sense of tranquility exists regarding these custodial accounts, lulling many parents into a false sense of security, thinking that they can maintain these accounts for as long as they wish.

This quiescent stage quickly ends, however, when officers at the bank or brokerage house where the custodial account assets are invested inform the parents that they must soon transfer title to the account into the child's name. Alternatively, an inquisitive child may ask the parents the source of the child's unearned income. It is at this stage of pending disclosure that parents are left to wonder what options, if any, they have to maintain account control.

There are four techniques parents may consider in order to defer the direct titling of the custodial account assets in their child's name. Depending on how a particular state's courts interpret UTMA, use of these techniques may prove successful. None of these strategies is foolproof, however, and each has risk associated with its use.

Repossession of Custodial Account Assets

The first thought that crosses the minds of hesitant parents whose child is approaching the specified distribution age is that they should reclaim title to the assets in the custodial account. After all, in many instances they were responsible for transferring title to the assets in the first place (other than gifts made by family members and friends).

Adopting this course of action, however, can result in significant hardship. In at least one case, a parent embarking on this kind of plan was convicted of first-degree larceny.[17] In another such case, the custodian was held liable for damages for negligence and breach of fiduciary duty.[18]

Many parents fail to realize that serving as custodian of assets they transferred may cause the FMV to be included in their own gross estate.

Estate of McGlaughlin, 483 N.Y.S.2d 943 (N.Y. Surr., 1985), illustrates that a court may nullify any attempt to prolong the custodial holding period. There, the parent had established UGMA accounts for the benefit of each of her two daughters. Prior to each daughter's attaining the age at which the accounts would terminate, each account was transformed from an account in the daughters' names for which the parent was custodian into a separate *Totten* trust in the name of the parent with each daughter named as the beneficiary.[19] Due to restrictions on vesting, the *McGlaughlin* court held that the parent's retitling effort was impermissible under UGMA. (The same consequences should hold true if a custodian uses custodial assets to fund a trust for the child's benefit, because legal ownership may be deferred or possibly eliminated.)

In the end, because retitling custodial account assets is beyond the scope of the custodian's powers and may be criminal in nature, parents should generally reject this approach.[20]

Using the Assets on the Child's Behalf

Some custodial parents will consider depleting the account by using the assets on the child's behalf before the

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[17] State v. Pompei, 726 A.2d 644 (Conn. App., 1999).

[18] Grover v. Grover, 1995 WL 584523 (Mass. App., 1995).

[19] A Totten trust is a payable-on-death account in which the "beneficiary" has no rights in the account unless and until the "owner" dies.

child attains the age of required disbursement. At first glance, this strategy appears permissible under the literal language of UTMA that allows a custodian to use, for "the minor's benefit, so much of the custodial property as the custodian considers advisable for the use and benefit of the minor..."[21]

All too often, the custodial accounts are substantial enough to disqualify the child for financial aid for college tuition and expenses.

Despite this literal language, state courts have unanimously ruled that no custodian may make custodial account expenditures for the child's benefit that parents are legally obligated to make from their own funds.[22] In states where a parent's duty of support extends to providing a college education,[23] for example, the courts' position effectively eliminates a custodian's ability to deplete the child's custodial account to any significant extent.

Only where the parents cannot meet their support obligation or the payment is one for which they do not have a direct duty of support (e.g., sending the child to camp) can custodial account assets be used on the child's behalf.[24]

This ponderous use restriction limits the overall effectiveness of this strategy.

Transfer to a Voluntary Long-Term Trust

When the child attains the age at which a custodial account terminates, the parents may ask that the child transfer the custodial account assets into a trust to be held for that child's benefit. The instrument may provide that assets will be retained in the trust for the child's benefit for many years.

Whether the child will accommodate the parents' request is another issue. But the parents often come to the table with many items that may prove persuasive. In particular, the parents can make clear that unless the child conforms and transfers the custodial account assets into a long-term trust, the child risks losing additional financial support and jeopardizes his or her ultimate inheritance.

This is not unique in the field of estate planning. Parents often establish what are known as "Section 2503(c) trusts." The requirements of these trusts are threefold:

1. The property and the income of the trust may be expended by or for the beneficiary only until age 21.

2. To the extent not expended, the property and accumulated income are available to the beneficiary at age 21.

3. If the beneficiary dies, the property and accumulated income must be paid to the beneficiary's estate or as the beneficiary appoints under a general power of appointment.

Frequently the parents who establish these trusts want the assets to remain in trust rather than be distributed outright to the child at age 21. Indeed, many of these trusts are drafted so that the beneficiary has a temporary window period of withdrawal at age 21; if this right is not timely exercised, the property remains in trust until the child reaches another designated age. The IRS has sanctioned this approach.[25] Another technique is to provide that at age 18, the beneficiary has a temporary window in which to postpone withdrawal beyond age 21.

The parents can make clear that unless the custodial assets are put into a long-term trust, the child risks losing his or her inheritance.

While being this heavy-handed with a child may work, some parents are reluctant to chance their child's acquiescence. For them, the fourth technique may prove a more attractive alternative.

Controlling the Investments

Custodians of UTMA accounts are given wide latitude in the investments they may make.[26] It appears that short of investing in assets of a highly speculative nature,[27] a court will not second-guess a custodian's investment choices. This judicial deference to custodians' investment choices gives parents a promising way to control the assets that pass to their children at the mandatory distribution age.

Given the investment latitude of UTMA, prior to the child's attaining the mandatory distribution age, the parents should form an LLC with their own investment assets.[28] The LLC's operating agreement should specify that members have no unilateral liquidation or withdrawal rights.[29] In addition, the parents should make themselves the LLC's managing members, so that all other members are non-managing members. The custodian (even if one of the child's parents) should then invest the custodial ac-

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20 The fact that a parent misunderstands the repercussions that stem from establishing a custodial account does not give the parent license to end the account and reclaim title to the custodial account assets. Gordon v. Gordon, 419 N.Y.S.2d 684 (App. Div., 2d Dept., 1979).

21 UTMA section 14.

22 See, e.g., Newman v. Newman, 123 Cal. App. 3d 618 (2d Dist., 1981) (a father holding property of his minor children as custodian under the UGMA could not use the proceeds of the property to satisfy a court order for support).

23 See, e.g., Thrasher v. Wilburn, 574 So.2d 839 (Ala. Civ. App., 1990) (a parent has a legal duty to provide, or to aid in providing, a college education if the child demonstrates the ability and willingness to attain a higher education and the parent has sufficient assets, earning capacity, or income to provide financial assistance without undue hardship to himself or herself).

24 See, e.g., Cohen v. Cohen, 608 A.2d 57 (N.J. Super. Ct., App. Div., 1992) (use of UGMA accounts to defray camp costs went unchallenged).

25 Rev. Rul. 74-43, 1974-1 CB 285.

26 See note 8, *supra*, and the accompanying text.

27 Buder v. Sartore, 774 P.2d 1383 (Colo., 1989) (UGMA and UTMA custodial investments in blue chips was acceptable, but penny stocks were not).

28 The parents should be careful not to trigger taxable gains on the establishment of the LLC. See Section 721(b).

29 Care also should be taken when drafting this agreement that the children will not have sufficiently large interests to be able to replace the LLC's manager.

count assets in the LLC.[30] When the child attains the age at which the custodianship terminates under state law, the child will become the outright owner of an interest in the family LLC, even though the child cannot directly control that asset. Thus, while the child has the economic benefit of the funds and will be entitled to pro rata distributions from the LLC (to the extent declared by the manager), it may be difficult for the child to obtain liquid funds or control of the assets without the approval of the manager/parent.

The judicial deference to custodians' investment choices gives parents a promising way to control the assets that will pass to their children.

This approach to maintaining control of custodial account investments can be extended beyond LLCs. The parent, for example, already may own a closely held corporate business, the shares of which are nonmarketable. The UTMA custodian could invest the custodial account assets in shares of this business.[31]

There are no reported cases where the bona fides of this tactic have been challenged. The absence of case law may signify either that few parents have used this technique or that this technique is not subject to challenge. More likely than not, however, many parents have successfully used this structure as a bargaining chip with their child to at least prolong control of the custodial account assets.

CONCLUSION

For simplicity and ease, transfers into custodial accounts have long been favored by well-intentioned parents of young children. As that child matures and the value of the custodial account grows, however, many parents have second thoughts about relinquishing control over these custodial accounts when their child attains the age at which distribution is required. This event is unsettling to parents who now perceive that a large distribution of substantial wealth may do their child more harm than good, by discouraging hard work or educational pursuits.

There are no perfect solutions for circumventing the mandatory distribution age requirements under UTMA. Even those strategies discussed above may not prove to be effective shields from a child eager to receive the balance of a custodial account. Nevertheless, given the alternative of a barely adult child who becomes a "millionaire," attempts at circumvention may be well worth the effort and the risk, even if these delaying tactics fall somewhat short. ■

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30 This approach also may reduce some administrative burdens by consolidating investment accounts (although the LLC will require its own tax return).

31 Prior to delivery of the shares, the parents may insist that the child sign a buy-sell agreement that further ties the child's hands.

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