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Custodial Accounts (UTMA/UGMA) for Education Savings

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What is it?

A custodial account is an account established at a financial institution for the benefit of a minor child and managed by the parent or another designated custodian. A custodial account is established under a particular state's Uniform Transfers to Minors Act (UTMA) or Uniform Gifts to Minors Act (UGMA).

Any money placed in a custodial account is gifted irrevocably to your child. While the child is a minor under the age of 18 or 21 (depending on the state), the money is controlled by the custodian and can be used only for the benefit of the child. Any income earned by the account is taxed to the child (though certain children are subject to the kiddie tax). When the child reaches the relevant age, the custodianship ends and the child assumes sole control of the money.

No separate legal forms or trust documents are required to establish the custodial account.

The custodian must comply with the particular state's UTMA/UGMA statute. Generally, the custodian has broad powers regarding investments and is not accountable to a court (unlike a guardian).

Tip: *Once the custodial account is established, there is no limit on who can contribute to it. So, in addition to parents, generous grandparents have a place to transfer money for the college education of their grandchildren.*

Caution: *State law may limit the types of assets that can be contributed to the custodial account.*

Differences between an UTMA account and an UGMA account

There are two differences between an UTMA custodial account and an UGMA custodial account. First, there are differences in what type of property each account may hold. The UGMA authorizes cash, bank accounts, stocks, bonds, mutual funds, and so on. The UTMA broadens these holdings to include real estate and other property, including limited partnership interests.

Second, UGMA accounts generally terminate at age 18, whereas UTMA accounts generally end at age 21, and in some states, age 25.

Most states have enacted UTMA to supersede UGMA.

Tip: *It is recommended you do not commingle an UTMA account with an UGMA account, because the earlier termination date (age 18) of the UGMA account may then apply to the UTMA account.*

Tip: *The longer duration of UTMA accounts (up to age 25 in some states) makes them more attractive to parents than UGMA accounts, because most parents are reluctant to hand over the account assets to their 18-year-old child, who, in most cases, is just starting college. Once the child receives the money, there is no requirement it be used for college expenses, and that cross-country trip can look mighty tempting.*

The kiddie tax

The "kiddie tax" rules apply to children who are (1) under age 18, or (2) under age 19 or a full-time student under age 24, provided the child doesn't earn more than one-half of his or her financial support. In 2019, the first $1,100 of unearned income is tax free, the next $1,100 is taxed at the child's rate, and any amount over $2,200 is taxed according to trust and estate tax rates.

Child's Age	Investment Income	Federal Tax Rate
Under 24	$0-$1,100	tax exempt
	$1,101-$2,200	child's rate
	over $2,200	trust and estate rate
24 and older	$0-$1,100	tax exempt
	over $1,101	child's rate

Tip: *To minimize the impact of the kiddie tax, parents might consider investing their child's savings in tax-free or tax-deferred investments, so that any taxable income is postponed until after the child reaches age 24 (when the child is taxed at his or her own rate). Such investments can include U.S. savings bonds, tax-free municipal bonds, or growth stocks (which provide little, if any, current income). Alternatively, parents can try to hold just enough assets in their child's name so that the investment income remains under $2,200.*

Caution: *The kiddie tax may make custodial accounts less effective as a college savings strategy.*

When can it be used?

You want to accumulate money for college in your child's name to take advantage of the potential tax savings

Any income earned by a custodial account is taxed to the child, not the parents. Because children are generally in a lower tax bracket than their parents, this will often result in tax savings. However, the expansion of the kiddie tax in recent years negates this advantage unless the child's annual unearned income is below a certain amount, as discussed above.

Strengths

Custodial accounts are relatively simple to establish and maintain

You can open a custodial account at your local financial institution, then simply contribute money whenever you want. Unlike a trust, there are no annual tax returns to prepare for the custodial account itself. You may need to file a tax return for the child if reportable income is high enough.

Custodial accounts exist with relatively low cost

You don't have to pay a trustee or pay an accountant to file annual tax returns. You can even save money on the custodian fee by acting as custodian yourself.

Custodial accounts provide an opportunity for tax savings

A custodial account creates an opportunity for tax savings for the first $2,200 of unearned income for a child who is under age 24, because the first $1,100 of unearned income is tax exempt, and then next $1,100 is taxed at the child's rate.

Tradeoffs

Custodianship ends and child gains control of the funds at age 18 or 21 (depending on the state)

When the child reaches age 18 or 21, the custodianship ends. This means that the child assumes sole control of the funds.

There is no requirement that your child use the money for college expenses

When your child receives the money at the age of majority, there is no requirement that the money be used for college expenses. This may pose a serious problem, especially in states where children gain control of the money at age 18, when college is just beginning. By contrast, if the child receives the money at age 21, hopefully most of the money in the custodial account has already been applied to the college bills.

Loss of parental control over assets unless parent is custodian

If you choose a third party custodian, you lose the opportunity to manage and invest the account assets.

Kiddie tax rules diminish opportunity for tax savings

The kiddie tax rules apply to children who are (1) under age 18, or (2) under age 19 or a full-time student under age 24, provided the child doesn't earn more than one-half of his or her financial support. Children in these categories are taxed at trust and estate

tax rates on all unearned income over $2,200.

Inflexibility of UTMA/UGMA statute

A custodial account is strictly governed by the particular state's UTMA/UGMA statute, and the custodian is bound to act accordingly. There is no opportunity to customize your account (as you can with a trust).

Negative impact on your child's eligibility for financial aid

A custodial account is in your child's name and thus included in your child's assets come financial aid time. Under the federal financial aid methodology, a child is expected to contribute 20 percent of his or her assets toward college costs, while parents are expected to contribute only 5.6 percent of their assets. The more a child is expected to contribute with the funds he or she already has, the less financial aid the child will be eligible for.

How to do it

Open an account at your local financial institution

A custodial account can be opened quite easily at your local financial institution. You will need your child's Social Security number.

Contribute money to the custodial account

Once you set up the account, you control when and how money is contributed to the account.

Tax considerations

Income tax consequences for child

Any income earned in a custodial account is taxed to the child, regardless of whether it is distributed. The reason is that a custodianship is not a separate legal entity or taxpayer (unlike a trust).

Under the kiddie tax rules, children who are (1) under age 18, or (2) under age 19 or a full-time student under age 24, provided the child doesn't earn more than one-half of his or her financial support, are taxed at trust and estate tax rates on all unearned income over $2,200. The first $1,100 of unearned income is tax free and the next $1,100 is taxed at the child's rate.

For children age 24 or older, the first $1,100 of unearned income is tax exempt, and any additional amounts are taxed at the child's rate.

Transfers to a custodial account qualify for the annual gift tax exclusion

For federal gift and estate tax purposes, transfers to a custodial account qualify for the $15,000 annual gift tax exclusion, even though the child's possession of the account assets is delayed until the child reaches the age of majority. If you transfer more than the annual gift tax exclusion amount to a custodial account in a given year, you may owe gift and estate tax.

Potential inclusion of custodial account in parent's estate

Property in a custodial account is included in a parent's gross estate if the parent who established the account dies while serving as custodian. This risk can be avoided if the parent who establishes the account (donor) names someone else as custodian. Because most families want to retain managerial control over the account, the donor/parent can name another close family member, such as the donor's sibling, as custodian. This way, control stays in the family without triggering the potential for inclusion of the account in the gross estate. If a non-donor spouse is chosen as custodian, it is possible for the IRS to assert estate tax inclusion for custodial funds held by the non-donor parent.

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