# Price & Farrington's Estate and Tax Planning *Fast* Faxts

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***Estate, Tax, and Wealth Planning For Advisors and Clients***

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## Avoiding the Five Biggest Pitfalls of Custodial Accounts: Traps for the Unwary

*Some estate planning topics are complex and nuanced, but without broad application. Other topics are simpler but apply to many clients, such as this month's topic. Read on...*

Estate and tax planning often involves the transfer of wealth to a younger generation through gift-giving. A common example is parents and grandparents making gifts to young children using the Uniform Transfers to Minors Act (UTMA). These "custodial accounts" are easy to set up under the child's social security number with an adult acting as custodian of the money. While these accounts are simple to establish and serve legitimate family estate planning purposes, they carry a number of serious traps for the unwary.

***Trap: Hidden Estate Taxes***. If the parent or grandparent names himself as custodian of the account, the funds will be included in his estate when he dies. If a reason for setting up the account was to cut estate taxes, it will backfire.

***Here's a better way:*** The donor should name someone other than himself as custodian, such as his spouse. *Caution:* The spouse named as custodian will control the account if the marriage gets rocky. A grandparent can name the child's parent as custodian to keep the account from being included in the grandparent's estate. If the wrong person has already been designated as custodian, a change can be made in the paperwork with the account's financial institution.

***Trap: Loss of control over the funds.*** Funds in a custodial account remain in the account until the child reaches age 18 or 21, depending on state law (21 in Washington). All of the money then falls under the child's control. While the funds may have been intended for education or some other noble purpose, there is no way to prevent a child from spending the money frivolously.

***Better way***: When modest amounts are involved—say, a $25 birthday gift or a $50 holiday present—custodial accounts are an easy way to handle the money. But where large amounts are concerned— for example, $11,000/$22,000 annual exclusion gifts—it is preferable to use a trust so that the child cannot obtain complete control at 18 or 21. With the trustee maintaining control, the funds can be held in the trust for as long as desired while being used for the child's benefit.

***Trap: Loss of college financial aid.*** Many people set up custodial accounts to save for a child's college education. For those who will need financial aid, this strategy is flawed. The financial aid formulas colleges use count funds in the child's name more heavily than funds in the parent's name. The result? A custodial account may limit a child's eligibility for financial aid.

***Better way:*** Parents and grandparents can save the funds in their own accounts to enable a child to qualify for aid. If they are financially able to help, they can pay college tuition directly. Such gifts are not limited by any dollar amount and can be made *in addition to* the limits on so-called annual exclusion gifts. These days, choosing one of the many new Section 529 Qualified State Tuition Plans is a good alternative.

***Trap: Possibility of a liability suit.*** The custodian is required by law to hold the funds of the account for the benefit of the child. As a practical matter, however, a custodian often deals with the funds as his own, especially when it is the custodian who put the money into the account. Where

*"I've called the family together to announce that, because of inflation, I'm going to have to let two of you go."*

there is family acrimony, the custodian might be brought to court for mismanagement of the funds. For example, after a bitter divorce, the wife might accuse the husband of using funds in the custodial account to meet his child support payments or other personal expenses.

***Better way:*** Respect the fact that the funds belong to the child. Keep good records of how funds have been spent. Understand that *the custodial account cannot be used to satisfy a parent's legal obligation to support the child.*

***Trap: Setting up a custodial account for asset protection***. It may not work. A minor child generally isn't liable for debts or other obligations. However, once the minor reaches the age of majority and gets control over the assets in the custodial account, his assets become subject to the claims of creditors. An accident, a lawsuit, divorce or bankruptcy can expose these assets to creditor claims.

***Better way:*** A much more effective technique is to use a trust rather than a custodial account for asset protection. Funds in the trust can be managed more effectively and made creditor-proof.

*For more on planning with and around custodial accounts, ask for our* **August, 2000 FastFaxts, "Gifts To Minors: Those Pesky UTMA Accounts".** ■

***Did you know...***

**"All taxes paid over a lifetime by the average American are spent by the government in less than a second." Jim Fiebig**