

CUSTODIAL ACCOUNTS – AN OVERVIEW

INTRODUCTION

“Custodial” account refers to an account established for a minor under the Uniform Gift to Minors Act of 1956, which was changed to the Uniform Transfer to Minors Act in 1986. It can be used to save for college, and it is a mechanism by which a minor can be the beneficiary of assets without the expensive and cumbersome process of establishing a trust. Trusts are more flexible—they can be tailored to your objectives—so their cost is justified at some point, probably when the gift is somewhere in the tens of thousands.

The custodian manages the account, its investments, the payment of taxes, and withdrawals for the minor’s use, but the minor owns the assets. When a gift is made to a custodial account, it is irrevocable. Taxes are determined according to the child’s tax liability. When the child becomes a major, the account will be in his/her name, and the assets are theirs to do with as they please. Age of majority is determined by the state law under which the account was open. Some states allow specifying an older age at the time the account is opened. I encourage doing this if you can, as an 18-year-old may use their new-found wealth unwisely.

COSTS INVOLVED

- **Contribution Limits:** There is no maximum or minimum for gifts/transfers to the account. Any gift over \$11,000 to one person in one year would be subject to the federal gift tax.
- **Fees and Expenses:** There are no specific fees or expenses for a custodial account, although the brokerage firm or bank may have administrative charges. Individual investments will have commissions or fees normally associated with trading.
- **Education Costs that Qualify for Withdrawals:** Withdrawals do not have to be for education; they only have to be for the child’s benefit.

TAXATION ISSUES

The [Smart Saving for College](#) site explains taxation of a custodial account: “For children younger than 14, the first \$750 in earnings in a custodial account is tax-free. The next \$750 in earnings is taxed at the child's federal tax rate in 2001. Any earnings over \$1500 are taxed at the custodian's federal tax rate. For children over 14, the first \$750 in earnings is still tax-free, and all earnings after that are taxed at the child's tax rate.” There are no state tax advantages.

THE BENEFICIARY

The beneficiary is also the owner of the account, even if only a baby. That is the real purpose of a custodial account: it allows a child to own stock and other assets, and it allows the transfer of property to a child. This is also the disadvantage of such an account: when the beneficiary is no longer a minor, the custodian no longer has any control over the assets.

FINANCIAL AID ELIGIBILITY

Holding assets in a child's name could impact financial aid. The financial aid formula usually expects a bigger contribution toward education costs from the student's assets than from a parent's: typically 35% of a student's assets vs. 5.6% of a parent's. So, if your tax bracket and income status are low enough to qualify for substantial aid, a custodial account with sizable assets could negatively impact the amount of aid received.

INVESTMENT CHOICES

Investment options are basically limitless. If your main goal is saving a bundle for college, the custodial account offers the most opportunity, as long as you or whoever makes the investment decisions makes good investments.

RECOMMENDATIONS

In my opinion the custodial account can be an attractive option under these circumstances:

- Your primary goal is to make a gift that will benefit a minor.
- You would like your gift to be invested for growth.
- You are comfortable letting the beneficiary choose how to use the assets of the account when he/she is no longer a minor.
- You want to promote an interest in and understanding of investments.

If you have other objectives and are interested in alternative college savings options, read the overviews on [529 plans](#) and [Coverdell Education Savings](#) accounts on this site.

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