Clarity WEALTH ADVISORS
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Custodial Accounts

Custodial accounts, also commonly referred to as a Uniform Gifts to Minors Act (UGMA) and Uniform Transfers to Minors Act (UTMA) are two vehicles set up in a child's name for the benefit of the child. They provide a straightforward and inexpensive method of making a gift or bequest to a minor without the expense of setting up and maintaining a trust. Any adult can establish a custodial account for a child under age 18.

How They Work

The custodian has the responsibility of managing the assets in an UGMA/UTMA for the benefit of the child until the custodianship ends, typically when the minor reaches the age of 18 or 21 (depending on the state the account is created in). These accounts must be used for the benefit of the minor. The assets held in a custodial account are owned by the child, even if he or she does not have control of those assets until a later date.

Contributions

There are no contribution limits to custodial accounts. However, contributions in excess of the federal gift tax limit will be subject to a gift tax. Currently, $14,000 ($28,000 if married) can be contributed to each custodial account and these irrevocable gifts immediately become property of the child. There is no lifetime limit to the aggregate amount that can be contributed as long as no more than the annual limit is contributed each year. Contributions are considered an irrevocable gift.

Distributions from Account

Distributions can be made from these accounts as long as they are for the benefit of the child. Withdrawals cannot be made for food, clothing, and shelter as these are considered parental obligations.

Investment Options

These accounts generally have no limitations of the stocks, bonds, mutual funds, and ETFs they can invest in. However, because to their custodial and protective nature, they are not permitted ownership of higher risk investments like stock options or buying on margin.

Taxation of Account

Since the assets in a custodial account are considered the property of the minor, the investment income is subject to the "kiddie tax" which comes into effect once income exceeds $2,000. Investment income includes dividends, interest, and any other earnings. For beneficiaries under age 19 and full-time students under age 24 whose earned income is less than one-half of their support, the first $1,000 of earnings is tax-free. Earnings between $1,000 and $2,000 are taxed at the child's rate and earnings above $2,000 are taxed at the parents' rate.

It is important to note that kiddie tax can be avoided if the child has earned a sufficient amount of income to provide over half of their support. In this case, the child's unearned income would be taxed at their tax rate, not the parents as this is known as the support test for the kiddie tax.

Age of Majority

Once the child reaches a certain age, the account would change to the child's name only where he or she has complete control and authority over the account. For example, in California, a custodial account will terminate when the minor turns age 18 unless a later age is specified, up to age 21.

That being said, the child can also decide to make the custodian a joint account holder or grant the custodian power of attorney (POA) on the account.

Financial Aid

For the purposes of financial aid, custodial accounts are considered assets of the child (student) and therefore do have an effect on their eligibility for financial aid. In calculating estimated family contributions toward college costs, the standard federal aid formula requires children to pay 20 percent of savings held in their name. In addition, income from these accounts will be considered in calculating the student's income and expected contribution amount.