New York Law Journal

NEWS

Trusts and Estates Law

Options When UTMA Beneficiary Nears Payout Age

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March 10, 2008


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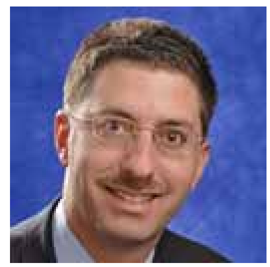
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The Uniform Transfers to Minors Act (UTMA) permits one person, a custodian, to hold the property of another person, the beneficiary, until the beneficiary reaches the termination age, usually 18 or 21.

While the beneficiary is underage, the custodian holds the property for the benefit of the beneficiary. While an UTMA account is inexpensive to create and a useful way for a parent to accumulate property for a child, the UTMA account has some limitations, the most pertinent of which is that the UTMA account belongs to the beneficiary once he or she reaches the termination age.

There are also other limitations which can cause some concern to a parent looking to transfer property to a child.

The Problem

As many of the readers of this article may recall, owning any substantial sum of money at the age of 18 or even 21 might have left them with a thought of how quickly could it be spent rather than invested. While there may be a minority of readers who were responsible enough to manage a substantial sum of money, many more would have needed a bit more supervision. Without this supervision, the word "squander" comes to mind. The beneficiary's own property from sources other than gifts can be contributed to the UTMA account. Also, the UTMA account may have been funded by gifts from the beneficiary's parent, and perhaps the UTMA account has a large balance in it as the beneficiary approaches the termination age. Understandably, the custodian may be considering his or her options as to the UTMA account, knowing that the beneficiary may not be ready to manage the property which is about to be available to the beneficiary. To make matters worse, there may already be a bone of contention as to this account between the beneficiary and the custodian.

Thus, the custodian must plan ahead to avert a fiscal (and perhaps a family) disaster. However, the law states that the beneficiary must have access to the UTMA property at the termination age. Preventing the beneficiary from accessing his own property may violate the fiduciary duty the custodian has to the beneficiary. What can a custodian do?

The custodian may consider transferring the UTMA property to the following: A trust for the benefit of the beneficiary; a limited liability company or limited partnership, or a Qualified Tuition Program under §529 of the Internal Revenue Code (a "529 Plan").

A custodian may favor a trust for the benefit of the UTMA beneficiary which will not end on the beneficiary's 18th or 21st birthday. Even with the best of intentions, the custodian may have violated his or her fiduciary duty to the beneficiary by restricting the beneficiary's access to the UTMA property after the beneficiary reaches the termination age. When the beneficiary does not have unfettered access to the UMTA property after the termination age, the custodian may have breached his or her fiduciary duty.

One attempt at a solution has been to request that the beneficiary, who has reached the termination age, create a trust for himself or herself. In this event, the beneficiary is the grantor of the trust, and restricts his or her own access to the trust property under terms upon which he or she has presumably agreed. This purported agreement may not be an agreement at all, if the beneficiary did not understand what he was doing. This may occur when the custodian is the parent of the beneficiary, the beneficiary's financial ability is suspect and the custodian is aware of the beneficiary's financial inability.

Imagine the beneficiary, often a child of the custodian, being led to the custodian's lawyer's office shortly after the beneficiary's 21st birthday, where a trust document is printed and waiting for the beneficiary's signature as the grantor. The beneficiary looks at the trust and, not really knowing what he has read, nevertheless signs the trust document, which appoints his parent, the custodian, as trustee. The beneficiary learns later that he was not required to sign the trust and he could have had the property in his own hands. Perhaps the beneficiary should hire his own independent counsel to protect his interest. After consulting with his counsel, the beneficiary may proceed with creating the trust. The custodian may then withstand a claim for breach of fiduciary duty.

It appears that planning with trusts at the termination of an UTMA should be done with the consent of the beneficiary. Doing otherwise may subject the custodian to a claim.

Limited Liability Companies

• ***And Limited Partnerships.*** Another possibility in planning for the UTMA beneficiary prior to the termination age is to invest in a limited liability company (LLC) or limited partnership (LP). For purposes of this article, LLC shall refer to both entities.

As with using a trust, the custodian's fiduciary duty is also relevant in determining whether the custodian can invest in an LLC. The beneficiary's ability to access the property at the termination age may restrict the custodian's ability to transfer UTMA assets to an LLC in exchange for an interest in the LLC.

Contribution by a custodian to an LLC affords less protection to the custodian than does a gift to the custodian, or purchase by a custodian from a member, of an LLC interest. Valuation discounts can work against the custodian when investing new property into an LLC. This occurs because after a member contributes property to an LLC, the value of the LLC interest is worth less than the proportionate interest in the underlying property. The discount in the valuation of a contributing member's LLC interest may subject the custodian to a claim.

In the case that the beneficiary is approaching the termination age and there are marketable securities in the UTMA account, then the custodian may purchase an LLC interest from an LLC member. The value of that purchased LLC interest should already reflect any valuation discount, so no reduction in value occurs after the exchange of the UTMA property for the LLC interest. Contrast this with the reduction in value after a contribution to an LLC in exchange for the LLC interest.

Related to the purchase, the custodian may receive a gift of an LLC interest. With this option, the LLC was created before the custodian even held the underlying property. A valuation discount would apply to the LLC interest before the gift. Thus, no value is lost by the custodian's actions. Further, the custodian need not worry about how to invest the UTMA property, since it was gifted to the custodian as an LLC interest.

Of course, purchasing an LLC interest from a member is not a transfer from the UTMA account to the LLC. The custodian must be cognizant of the risks associated with any investment, and this type of investment is no exception. The custodian's fiduciary duty may not be properly discharged when investing in a family LLC with no demonstrated history of return on investment and no financial statements to review, among other limitations. However, this may further reduce the purchase price of the investment until a custodian who made such a purchase with UTMA assets can defend the investment.

529 Plans

New York's 529 Plan permits the investment of UTMA property into a 529 Plan. Contribution of UTMA property to a 529 Plan superimposes new restrictions to the 529 Plan in addition to the UTMA restrictions, rather than subjecting the contributed property solely to the 529 Plan rules. This is important since an account owner of a pure 529 Plan (one without any contributions from an UTMA account) may change the plan beneficiary at any time. Also, the account owner of the pure 529 Plan may continue to be the account owner until he or she decides to name a new account owner.

However, the UTMA/529 Plan beneficiary can become the account owner of the 529 Plan upon reaching the termination age. Another restriction is that the UTMA/529 Plan beneficiary cannot be changed. Of course both these restrictions and others originate with the UTMA rules.

Conclusion

With some planning, the custodian can minimize the chance that the beneficiary will squander the property at an early age. As noted above, a custodian has a few options to attempt to protect the beneficiary's property so that it may be available for the beneficiary when he or she can more appropriately manage that property.

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