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More on Gifting to Minors - Custodial Accounts

By Gary A. Phillips & Steven M. Saraisky - June 21, 2011

We recently posted a blog article on the choice between gifting to a 529 Plan or a Minor's Gifting Trust. There is a third option – transferring assets to a custodial account for the benefit of a minor. In New Jersey and New York, these gifts would be made under the Uniform Transfers to Minors Act ("UTMA").

A donor can create an UTMA account for the benefit of a minor beneficiary, and can gift annual exclusion gifts (or larger amounts which would then utilize a portion of the donor's lifetime applicable exclusion amount). The account is owned by the minor and as a result the minor is the taxpayer. While the beneficiary is a minor, the designated custodian is in control of the account and makes all investment and distribution decisions. Unlike a 529 Plan, the growth inside the UTMA account is subject to income tax and distributions are not limited to higher education. Interestingly, if the custodian has a legal obligation to support the beneficiary, and the custodian dies while the beneficiary is a minor, the custodial account will be included in the custodian's taxable estate.

The major disadvantage of gifting to an UTMA account is the minor beneficiary becomes entitled to the account upon attaining age 21. Under most circumstances, it is not advisable for a 21 year old to be the recipient of a sizeable sum of money at the time when maturity, life experience and knowledge all are just beginning to develop. The much better alternative is a Gifting Trust that can prescribe restricted but flexible terms for the beneficiary to receive assets.

Prior to 1987, one of the advantages of transfers to UTMA accounts was that, by transferring assets to these accounts, the assets were then taxed at the child's generally lower income tax rate, rather than the parents' tax rate. Congress adopted the "Kiddie Tax" in 1986 which eliminated this tax benefit. The Kiddie Tax today provides that for investment income for children under age 18 (and dependent children under age 24 who are full time students), amounts in excess of $1,900 will be taxed at the parents' tax rate. The age was originally 14 but Congress changed the age to 18 in 2006.

Thus, the income tax advantage of the UTMA account has largely been eliminated. As a result, gifting to Gifting Trusts and/or 529 Plans (for gifting for higher education expenses) is generally preferable.

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