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Protecting Children From Their Money

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THE first savings fund that many parents and grandparents set up for young children is a custodial account at a bank, mutual fund company or brokerage house. This simple, low-cost route designates an adult to oversee money for a minor.

Often the goal is to create a nest egg to cover college or postgraduation expenses, like the down payment on a house, seed money for a start-up company or a subsidy for a low-paying first job.

But young people are legally entitled to the money when they reach age 18 or 21, depending on the state. By then they might have other ideas about how to spend it. Or maybe the pot has grown so large that the person does not have the financial acumen to handle it.

One custodial account was worth more than \$5 million when a distressed parent consulted Susan T. Bart, a lawyer with Sidley Austin in Chicago. The account, created when the child was an infant, was financed with interests in a family business and mushroomed as the company prospered.

The parent, who was the custodian, was concerned that an influx of cash at age 21 would reduce the child's motivation to get an education and work.

Ms. Bart's client was suffering from what lawyers call "U.T.M.A. regret," referring to the Uniform Transfers to Minors Act, the law that most states have adopted to regulate custodial accounts. Under the act, the child owns the money as soon as it goes into the account and can claim it (or sue for it) at the specified age.

The closer that children get to that age and the larger the account, the more hand

wringing there tends to be, said Kaye A. Thomas, a tax lawyer whose Web site, fairmark.com, includes a message board where parents can vent about the subject.

Meanwhile, custodians have a duty to prudently invest the money and put the child's welfare first. Because of this fiduciary role, custodians cannot just take back the money or invest it all in savings bonds with the hope that the child won't find out.

Though these may seem like obvious solutions for parents who think that the U.T.M.A. accounts are too large, said Jay A. Soled, a professor at Rutgers Business School, they would be illegal.

But here are other strategies for managing the account, all of which can be combined:

¶ Spend it down. You can't use these accounts for support obligations (food, clothing and shelter), but it's generally safe to apply the money to luxuries, like private school, dance lessons and summer camp, said Stephanie E. Heilborn, a lawyer with a practice in New York.

¶ Invest in a Section 529 plan. Although this designates the money for higher education, it does not remove it from the U.T.M.A. rubric, Ms. Bart said. The child can therefore take out the money and use it for something else. There is a financial drawback to doing this, though: as with any 529 account, if the money is not used for college or graduate school, withdrawals are subject to income tax and a 10 percent penalty.

Before moving U.T.M.A. money into one of these plans, you must create a "custodial 529," Ms. Bart said — it can't go into a regular 529 account that may

already exist for that child's benefit. In addition, since only cash can go into 529 accounts, it may be necessary to liquidate custodial assets first, which could mean paying tax on any gains.

¶ Invest in an asset that can't be readily converted to cash. The one most commonly mentioned is a family limited partnership. Here you put property — assume it's publicly traded stock — into a partnership, and then give or sell shares of that partnership to family members. In effect, those shares are illiquid because few people outside the family would want to buy them.

While this technique can help save estate taxes, using custodial money to buy shares of a family partnership is problematic, Ms. Heilborn said. Among other things, the custodian could be accused of breaching the fiduciary duty if the child can't liquidate the partnership interests after reaching the legal age.

¶ Transfer the money to a Section 2503(c) trust. This irrevocable trust has only one beneficiary and officially ends at age 21. Although it may sound no better than an U.T.M.A. account in that respect, lawyers have developed a way to work around that: they give the child a window of time — usually 30 or 60 days — to terminate the arrangement, and if the beneficiary doesn't end it at 21 the trust continues for a predetermined number of years.

In other words, a child who doesn't act within the limited time frame must wait for the money, but with an U.T.M.A. account, once he or she has reached the magic age the money can be claimed at any time, Ms. Heilborn said.

Therefore, most lawyers say this is the best remedy for overfunded custodial accounts; it was the one Ms. Bart used for her client's U.T.M.A. regret. It is also a great alternative to these accounts in the first place.

Some states allow the custodian to transfer assets to one of these trusts before the child reaches legal age and terminate the account (setup cost: about \$3,000 to \$5,000). Elsewhere, you must wait and get the child's permission.

Gentle persuasion — for instance, “A trust is a good way to protect assets from creditors” — is sometimes enough, Ms. Heilborn said. But strong-arm tactics — like, “If you don't set up one of these trusts, I will reduce what I leave you as an inheritance” — are also legal.