VOLUME 23, ISSUE 5

LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

What Financial Professionals Need to Know About UTMA Accounts

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The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Life insurance and financial professionals work with clients who plan to leave money to family members. Sometimes family members who are in line to receive that money are too young to handle it properly.

In a perfect world our clients would always create trusts to manage and distribute money for young beneficiaries. However, trusts cost money and require substantial effort to create. They are also costly and time-consuming to administer. For a substantial portion of the population, trusts are not an effective way to take care of young beneficiaries.

To help create practical choices for taking care of money for young family members, state governments came together essentially to create simplified trusts. The first set of these rules was the *Uniform Gifts to Minors Act (UGMA)*. Since UGMA and its variations were enacted, state governments have come up with a new, improved version of the rules called the *Uniform Transfers to Minors Act (UTMA)*.

Together, UGMA and UTMA accounts are referred to as *custodial accounts*. Custodial accounts name a minor beneficiary and a custodian, who acts on the minor's behalf and is likely to be a responsible adult.

Regards,
Michael W. Lagos, CFP®

What Financial Professionals Need to Know About UTMA Accounts

Financial professionals need to explain to their clients:

- how UTMA accounts work,
- what state nuances are relevant,
- how a custodian should be picked,
- how accounts are taxed, and

what happens when the beneficiary reaches the age of majority.

Advisors should also be able to tell their clients when a custodial account is the right tool, when it is inadequate, and when a trust should be drafted instead.

UGMA AND UTMA

UGMA and UTMA were originally proposed by the *Uniform Law Commission (ULC)*. That organization is a nonprofit group whose purpose is to provide clear, stable, and consistent laws to all states in those legal areas where uniformity is especially desirable. The ULC is made up of lawyers from each state.

The ULC adopted the Uniform Gifts to Minors Act (UGMA) in 1956. The original version of UGMA closely followed model rules sponsored by the New York Stock Exchange and the Association of Stock Exchange Firms. The original version of UGMA broadened the version suggested by the stock exchanges to cover gifts of money as well as securities.

In 1965 and 1966 the ULC revised UGMA to expand the kinds of financial institutions that could serve as depositories of custodial funds, to facilitate the designation of successor custodians, and to add life insurance policies and annuity contracts to the types of property that could be included.

Not all states adopted the revisions, creating a lack of uniformity in UGMA. The ULC adopted the Uniform Transfers to Minors Act (UTMA) in 1986. UTMA expands the types of property that can be transferred to a minor and provides for other types of transfers besides gifts, such as testamentary transfers.

As of 2022, all states, plus the District of Columbia, have now adopted UTMA. The two most recent UTMA-approving states are Vermont (2015) and South Carolina (2022). For most purposes related to life insurance, annuities, or financial products, the principles of UTMA or UGMA that apply to those accounts are the same.

State Variations

Throughout this article we will make references to the provisions of UTMA. These refer to the model act. Each state has its own version of the rules for custodial accounts, although the differences tend to be minor. The chart at the end of this newsletter lists the statutory source for the state's UTMA rules. Check with your own state's rules to find any important differences from the model act.

While all states have adopted UTMA, in some cases UGMA accounts may still exist, primarily because they were established prior to approval of UTMA rules.

Requirements

The UTMA model language makes clear that a custodial account is intended for just one beneficiary and that just one person is responsible for the administration of the account:

> *A transfer may be made only for one minor, and only one person may be the custodian. All custodial property held under this [Act] by the same custodian for the benefit of the same minor constitutes a single custodianship.*

Transfers to minors can occur in several ways—including by gift, by testamentary transfer, and by sale. When working with life insurance or annuity policies, it is possible for a custodian account to be either the beneficiary of the policy or the owner or both.

The following language should be used to name a custodial account owner or beneficiary under the UTMA model act:

> *(Name of custodian) as custodian for ____________________ (name of minor) under the (Name of Enacting State) Uniform Transfers to Minors Act*

INVESTMENTS

Restrictions are few on the kind of property that can be transferred under the UTMA model act. Any asset that can have an ownership designation, and which the minor has a right to own, can be held by a custodian for the benefit of a minor.

CUSTODIANS

The model UTMA act allows for any adult to act as custodian. The act also permits a trust company to act. In the event the named custodian will not perform the duties of custodian, the act also permits the person creating the custodial account to name a contingent custodian.

If no successor custodian is named, the UTMA rules permit donor, minor over 14, or minor's legal representative to choose a successor, depending on the circumstances.

The UTMA custodian is entitled to reimbursement for expenses incurred in his or her capacity as custodian. The custodian is also allowed to elect, on an annual basis, to be reasonably compensated for time related to administration of the UTMA account during the year. The right to compensation is *not available* if the custodian is also the donor.

The account beneficiary can ask for an accounting with respect to the account under the UTMA rules when the beneficiary is age 14 or older. If the beneficiary is younger, or if other circumstances warrant, a court can also order an accounting.

The donor of a custodial account will want to take the same kind of care in picking a custodian as the donor would use in picking a trustee of a trust. The custodian should be honest, good with money, and trusted to act in the best interest of the minor beneficiary.

USE OF FUNDS WHILE CUSTODIANSHIP IS ACTIVE

Section 14(a) of the Uniform Transfers to Minors Act says:

> *A custodian may deliver or pay to the minor or expend for the minor's benefit so much of the custodial property as the custodian considers advisable for the use and benefit of the minor, without court order and without regard to (i) the duty or ability of the custodian personally or of any other person to support the minor, or (ii) any other income or property of the minor which may be applicable or available for that purpose.*

Most state versions of that provision are at least as liberal regarding the custodian's powers. So long as money spent from the account is spent for the minor, the custodian is probably meeting her fiduciary obligation under UTMA.

What if the custodian uses money from the custodial account in a way that is not permitted?

Under those circumstances the custodian's potential liability is similar to that of a trustee who ignores fiduciary obligations to the trust beneficiary's. The custodian and trustee would potentially be open to criminal prosecution, as well as civil liability to the beneficiary.

DISTRIBUTION AT AGE OF MAJORITY

What choices are available to the custodian when the minor becomes an adult? None. The law says that the account *must* be turned over to the account beneficiary. The custodian control ends, and whatever is in the account becomes controllable solely by the beneficiary.

Each state has its own definition regarding when the age of majority occurs. For most the age is either 18 or 21. A chart at the end of this newsletter lists each state's age of majority, as well as the statutory source for the state's UTMA rules.

Some states have built flexibility into the adult's ability to choose an age of majority for UTMA purposes. For example, Tennessee allows an UTMA account to be created that sets the age of majority as late as 25. Here's what that state statute says about electing an age older than 21 at Section 3507-121:

> The custodian shall transfer in an appropriate manner the custodial property to the minor or to the minor's estate upon the earlier of:
>
> > The minor's attainment of twenty-one (21) years of age; provided, that this transfer can be withheld until the minor's attainment of up to twenty-five (25) years of age if the instrument so provides, and if the gift is an inter vivos gift, the instrument further expressly states that deferring termination of custodianship beyond the minor's attainment of twenty-one (21) years of age will cause the transfer to be a gift of a future interest which may have adverse federal and state gift tax consequences; or . . . (t)he minor's death.

If a client wishes to elect a special distribution age for a minor in a state that allows such a flexible designation, the state statute and the account provider should be consulted regarding appropriate language.

Tax Issues

Custodial accounts are often funded with gifts from parents or grandparents. Such gifts are subject to normal federal gift-tax rules, including annual exclusion limits and lifetime exemptions. There are no special exemptions from gift tax rules for custodial accounts.

The income and estate tax status of UTMA or UGMA accounts should also be considered.

FEDERAL INCOME TAX

For the most part, UGMAs and UTMAs don't have any special tax rules. The use of a custodial account to hold an asset does not affect its taxation. For instance, if the UTMA account holds an NQDA and money is withdrawn, the earnings portion will be subject to the 10 percent penalty for distribution prior to age 59 1/2. The fact that it's in a UGMA or UTMA offers no exemption from the penalty.

The minor's Social Security number is listed on the account records, and generally the minor is liable for any tax on income.

However, if the custodian uses custodial income to discharge the legal obligation of any person to support the minor, such income is taxable to the person with the support obligation. Thus, the parent will be taxed with the income if the custodian used the fund to pay the minor's college expenses and the parent has the support obligation to pay the minor's college expenses under the applicable state law. See Rev. Rul. 59-357, 1959-2 CB 212.

At one time wealthy families could save a great deal of money by transferring investment assets to children. Thousands of dollars in taxable investment income could be shifted to children at lower rates that apply to individuals who have relatively little income. Congress decided to reduce or eliminate this tax benefit with the *kiddie tax* rules. Although kiddie tax rules changed for a short time as a result of the Tax Cut and Jobs Act, in the past few years the tax has changed back to more closely conform to its original intent.

The investment income threshold at which the kiddie tax kicks in is twice the amount allowed as a standard deduction for a dependent who has only investment income. For 2023, the investment income threshold is $2,500. This means a minor having investment income of less than $2,500 will pay tax at the minor's own bracket. For investment income over $2,500, the kiddie tax applies, and the investment income will be taxed at the parents' bracket.

Here's an example of how the kiddie tax works:

> Suppose the child has investment income of $2,900 and no other income. The first $1,250 of investment income escapes taxation. The next $1,250 is taxed at the child's rate of 10 percent. That leaves $400 to be taxed at the parents' bracket. If the parents are in the 32 percent bracket, the tax would be 10 percent of $1,250 plus 32 percent of $400 for a total of $253.

The kiddie tax applies in the following situations where investment income is more than $2,500 from UTMA accounts or other sources:

- Until the year the child turns 18, the kiddie tax applies automatically.
- In the year the child turns 18, the kiddie tax applies unless the child's earned income is more than one-half of his or her overall support. Earned income means income earned by working and does not include investment income.
- For the year the child turns 19 though the year the child turns 23, the kiddie tax applies to a child who is a full-time student during any part of at least five months during the year unless the child's earned income is more than one-half of his or her overall support.

The kiddie tax does not apply if the child is married or if both parents were deceased by the end of the tax year in question.

Since the minor is treated as the owner of the account during custodianship, there is no income or gift taxable transfer with respect to the account when the custodianship expires and the beneficiary takes control of the account.

FEDERAL ESTATE TAX FOR DONOR ACTING AS CUSTODIAN

In most cases where a parent makes a gift of property to a child, the parent will be inclined to appoint himself or herself as custodian. If that happens and the parent dies while serving as custodian, the value of the custodial property will be included in the custodian's gross estate for federal estate tax purposes under the retained interest rules of IRC Section 2036.

The potential issue can be avoided by naming a different adult relative as the custodian of the UTMA account.

College Funding

Parents planning for their children's college education expenses sometimes plan to put money aside in various financial vehicles to fund for the liability. In many cases they will consider titling the account in the name of the intended recipient using a UTMA.

Most UTMA accounts will be counted as part of the child's own assets for federal financial aid (FAFSA) purposes. Federal college-needs analysis formulas have a built-in assumption that more of an asset in the child's name is available to spend for college than the same asset in the parents' name. So in general, assets intended to fund college expenses should be kept in the parents' names to maximize financial aid eligibility.

CUSTODIAL ACCOUNTS VS. TRUSTS

Custodial accounts are essentially simplified trusts, so it is fair to compare their advantages and disadvantages to customized trusts.

Trusts, whether created while living or at death, have the following advantages over custodial accounts:

- A trust is not limited to minors.
- Longer duration is possible.
- It is more flexible on how to use money.
- More than one beneficiary is OK.
- More than one trustee is OK.
- Measured release of control in favor of the beneficiary is permitted.
- A trust can be structured to meet a number of objectives, including special needs.

An UTMA account has the following advantages over a trust:

- It is generally cheaper and easier to set up than a trust.
- It is generally easier to maintain than a trust.
- Financial institutions are familiar with the standard rules.

CONCLUSION

A custodial account, generally created under a state's UTMA rules, is a simpler alternative to a trust for a minor. The account is created simply by using the words provided by state law, and all the provisions of the law will apply to the account.

While simple and cost-effective to create, custodial accounts are less flexible than trusts. In cases where our clients want flexible control over the beneficiary's asset, using a trust rather than a custodial account should be considered.

State	State Statute Section	Age of Majority
Alabama	Section 35-5A	21
Alaska	Title 13, Chapter 46	Up to 25
Arkansas	Title 9, Subtitle 3, Chapter 26, Subchapter 2	Up to 21
Arizona	Section 14-7651 et seq.	21
California	Probate Code Sections 3900-3925	Up to 25
Colorado	Section 11-50-101 et seq.	21
Connecticut	Chapter 802d, Secs. 45a-546 et seq.	21
Delaware	Title 12, Chapter 45, Section 4501 et seq.	21
District of Columbia	**SECTION 21-301 ET SEQ.**	18
Florida	CHAPTER 710	Up to 25
Georgia	Title 44, Chapter 5, Article 5	21
Hawaii	CHAPTER 553A	21
Idaho	Section 68-801 et seq.	21
Illinois	Section 760 ILCS 20/	21
Indiana	Section IC 30-2-8.5	21
Iowa	Section 565B.1 et seq.	21
Kansas	Section 38-1701 et seq.	21
Kentucky	Chapter 385	18
Louisiana	RS 9:751 et seq.	18
Maine	Title 33, Chapter 32 Section 1651 et seq.	Up to 21
Maryland	Section 13-301 et seq.	21
Massachusetts	Part 2, Title 2, Chapter 201A	21
Michigan	Section 554.521	Up to 21
Minnesota	Section 527.21 et seq.	21
Mississippi	Section 91-20-1 et seq.	21
Missouri	Chapter 404.005 to Chapter 404.094	21
Montana	Title 72, Chapter 26	21
Nebraska	Section 43-2701 et seq.	21
Nevada	NRS 167.010 et seq.	Up to 25
New Hampshire	Section 463-A:1 et seq.	21
New Jersey	Section 46:38A-1 et seq.	21
New Mexico	Section 46-7-11 et seq.	21
New York	Section 7-6.1 et seq.	21
North Carolina	Chapter 33A	21
North Dakota	Section 47-24.1 et seq.	21
Ohio	Section 5814.01 et seq.	Up to 25
Oklahoma	Section 58-1201 et seq.	Up to 21
Oregon	Section 126.805 to Section 126.886	21
Pennsylvania	Title 20, Section 5301	Up to 25
Rhode Island	Chapter 18-7	21
South Carolina	Section 63-5-601 et seq.	21
South Dakota	Section 55-10A-1 et seq.	18
Tennessee	Section 35-7-101 et seq.	Up to 25
Texas	Title 10, Subtitle A, Section 140.001 et seq.	21
Utah	Section 75-5a-101 et seq.	21
Vermont	Title 14, Chapter 115	21
Virginia	Section 64.2-1900 et seq.	Up to 25
Washington	Chapter 11.114 RCW	Up to 25
West Virginia	Section 36-7-1 et seq.	21
Wisconsin	Section 54.854 et seq.	21
Wyoming	Section 34-13-114 et seq.	21

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IN THIS ISSUE OF ADVISOR'S BULLETIN

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LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

IMPORTANT NOTICE: PLEASE READ