

# Custodial Accounts: What Parents and Grandparents Should Know

Custodial accounts for children are established for various reasons. Grandma gave \$10,000 to little Jennifer: set up a custodial account. Mom and Dad want a tax shelter for little Johnny's college savings fund: set up a custodial account. However, many folks who establish custodial accounts fail to recognize that they have significant legal and tax implications.

Here are five important facts parents (and grandparents) need to understand.

## 1. The Money Now Belongs to the Child

Once funds are transferred into a minor child's custodial account at a financial institution or brokerage firm, the funds then irrevocably belong to the child. While the parent can, and usually does, function as the custodian (manager) of the account, the money can legally be used only for expenditures that benefit that child. In other words, parents are legally forbidden from using custodial account money for expenditures that benefit themselves (like a new car). And they cannot take money from one kid's custodial account and use it to open up or supplement an account for another kid.

Obviously, it can sometimes be a fine line between expenditures that benefit the child and those that benefit other family members, and you rarely hear about parents getting into legal hot water for dipping into custodial accounts. That said, you don't want to stray over the line.

## 2. The Kid Will Gain Control at a Relatively Young Age

A minor child's custodial account must be established under the applicable state *Uniform Gifts to Minors Act* (UGMA) or *Uniform Transfers to Minors Act* (UTMA). Most states have UTMA regimes these days. In any case, under applicable state law, the child will gain full legal control over the account once he or she ceases to be a minor. This will happen somewhere between age 18 and 21 (in most states the magic age is 21).

*Remember:* Nice little kids eventually may turn into obnoxious teenagers and young adults who are irresponsible. So parents should consider the possibility of future "UGMA or UTMA regret" before taking the irrevocable step of putting a substantial sum into a child's custodial account.

## 3. The Child May Have to File Tax Returns and Pay Taxes

Any income from a child's custodial account belongs to the child. If that income exceeds \$1,050 for 2017 (and 2016), a separate federal income tax return generally must be filed for the child using Form 1040, 1040A, or 1040EZ. The child will probably owe some tax, and the Kiddie Tax rules may make it higher (see below). A state income tax return may be required too.

*Exception:* If all of the child's income consists of interest, dividends, and mutual fund capital gain distributions, the parent may be eligible to simply include the income on the parent's Form 1040 and pay the resulting extra tax with that return. Details about this option are explained on IRS Form 8814 (*Parents' Election to Report Child's Interest and Dividends*).

#### 4. The Kiddie Tax Might Apply

It would be nice if children with substantial custodial accounts were allowed to pay the same tax rates on investment income as other unmarried individuals. If that was allowed to happen, a child's ordinary income would typically be taxed at a federal rate of only 10% or 15%. Unfortunately, Congress created the so-called Kiddie Tax to prevent such happy outcomes.

Under the Kiddie Tax rules, a minor child's investment income in 2017 (and 2016) above \$2,100, which may come from assets in a custodial account, may be taxed at the parent's higher rates. This is true even if all the money to fund the custodial account came from a grandparent or someone else other than a parent.

The Kiddie Tax is calculated on Form 8615 or on the aforementioned Form 8814 (when allowed).

*Important Point:* In the good old days years ago, a child's custodial account could function as efficient tax shelter because the income was taxed at the child's low rates. These days, the Kiddie Tax rules make it more difficult for custodial accounts to deliver meaningful tax savings.

#### 5. There Could Be Gift Tax Consequences

For 2017 (and 2016), a parent can take advantage of the annual federal gift tax exclusion to move up to \$14,000 into a custodial account for each of his or her children. If the parent is married, so can the spouse. Parents can do the same thing year after year. Gifts up to the \$14,000 annual limit will not reduce the parent's unified federal gift and estate tax exemption (\$5.49 million for 2017, up from \$5.45 million in 2016).

However if a parent transfers more than \$14,000, a gift tax return must be filed on Form 709 (*United States Gift and Generation-Skipping Transfer Tax Return*) even when no gift tax is due. Depending on the current estate tax exemption amount, the parent probably will not actually owe any gift tax, but a gift tax return still must be filed.

The same gift tax considerations apply to gifts by grandparents and others.

**Conclusion:** Custodial accounts are not as simple as advertised and there is even more involved that can be explained in this article. For example, a healthy custodial account balance can reduce college financial aid awards. Please contact your advisor if you want more information about custodial accounts for children.

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