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Custodial Accounts for Kids Under 18

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Many parents, grandparents or other adults may wish to transfer assets such as money or property to a child using a will or some other estate planning method. However, many adults think 18 (the legal age of adulthood in South Dakota) is still too young for the child to take responsible control of a large sum of money or other assets. They believe that the child’s lack of financial experience and expertise could result in unwise use of the property.

A custodial account is one alternative for a parent or other adult who wants to make gifts of assets during life, bequests with a will, or distributions from a trust for the benefit of a child who is under 18.

This fact sheet explains custodianships that are permitted under the South Dakota Uniform Transfers to Minors Act that was enacted by the 1986 legislature. This Act applies to anyone making asset transfers to minors – children, grandchildren, nieces, nephews, and other relatives or friends.

**What is a custodianship?**

A minor as defined for purposes of this law is a person who has not reached the age of 18.

An individual who transfers assets to a custodial account is referred to as a transferor. Although assets placed in the account are for the child, control is not transferred to the child until he or she reaches age 18.

A custodian manages the property that has been irrevocably transferred to a custodial account for the benefit of a child who is under the age of 18. The custodian can be the transferor (such as a parent or grandparent), another adult, or a trust company.

The Act applies to transfers of property to a child while a transferor is alive, as well as a transferor’s bequest in a written will.

The Act also pertains to distributions to a custodian from a trust arranged while the transferor is alive or from a trust established by the transferor’s will.

**Custodians, guardians, conservators, trustees – what is the difference?**

A guardian is one who is legally empowered by the circuit court to take care of a child who is considered by law to be too young to care for himself. The guardian takes care of the child until he or she reaches age 18. A parent can nominate a guardian in a will.

A conservator is legally empowered by a circuit court judge to manage the financial affairs of a protected person, such as a minor child. A parent can nominate a conservator in a will. The conservator manages the assets of a child until he or she reaches age 18. A child’s guardian and conservator do not have to be the same person.

Although children under the age of 18 may receive gifts of assets (such as cash, stocks, and bonds) and hold title to property, South Dakota law significantly limits their legal capacity to act on their own behalf. Children under 18 are unable to enter into binding contracts such as the purchase of real estate, credit card agreements, and loans.
A custodian is named by a transferor and is responsible for managing the assets in a custodial account for the benefit of a child until he or she reaches age 18. A custodian can be named while the transferor is alive.

A trustee named in a trust instrument is given the power to manage trust assets and use them for the purposes outlined in the trust agreement. Typically, a trustee is directed to use assets for the health, maintenance, support, and education for a child. The trust agreement can indicate any age at which the trust terminates and the proceeds are distributed to the child.

Many adults believe that age 18 is too young to give a person control of substantial sums of money or property. This may be of even more concern if the transferor hopes to make a number of substantial gifts to a child over time. A transferor who desires to defer a child’s access to property beyond age 18 could create a trust for the benefit of the child. A trust agreement can establish any age for trust termination and distribution of property to a child, well beyond age 18. A trust is a very flexible estate planning tool, but the trust agreement is a legal document that should be prepared by an attorney. Thus, a trust will usually involve more complexity and expense than setting up a custodial account.

What assets can be transferred to a custodial account?
Almost any type of property, including money, securities (stocks and bonds), certificates of deposit, savings accounts, U.S. savings bonds, and real estate can be transferred to a custodial account.

In addition, a custodian may be designated as the beneficiary of insurance policies, pension, or profit sharing plans or similar future payment rights. Any income or proceeds from the custodial property, such as interest, dividends, or rental income also becomes custodial property.

Whom should I designate as custodian?
A transferor can designate himself or herself, another adult, or a trust company to serve as custodian. Only one custodian can be named for each account – joint custodianships are not allowed.

A transferor, however, may designate another person as a substitute or successor custodian to whom the property must be transferred if the first custodian dies, is unable, declines, or is ineligible to serve.

What are the duties of the custodian?
The custodian manages registers or records title to custodial property (if appropriate, such as in the case of real property), and collects, holds, manages, invests, and reinvests custodial property.

A custodian keeps records of all transactions regarding the custodial property, including information necessary for the preparation of the child’s tax returns. Because parents are responsible for filing tax returns for their children, a custodian who is not the parent should share the 1099 interest reporting form issued by the financial institution with the parent or legal representative.

A custodian must observe the standard of care that would be observed by a “prudent person” dealing with property of another. If the custodian has special skills or expertise, the skills or expertise must be used. The custodian is required to identify and keep custodial property separate from other property. Custodians are not allowed to pledge the account as collateral for any loans to themselves.

A custodian may resign at any time by delivering written notice to the child, if he or she has reached the age of 14. The written notice must also be sent and the custodial property delivered to the successor custodian.
Where can a custodial account be set up?
Custodial accounts can be established at a bank, a savings and loan, a credit union, with a mutual fund company, or at a brokerage firm. The child’s social security number is the taxpayer identification for the custodial account.

What is the format to use on a custodial account?
A parent can designate a custodian to manage the property for his or her child by naming the custodian followed by the words “as custodian for (name of the minor) under the South Dakota Uniform Transfers to Minors Act.”

An instrument in the form below also satisfies the requirements of South Dakota law.

Transfer under the South Dakota Uniform Transfers to Minors Act

I (name of transferor or name and representative capacity if a fiduciary), hereby transfer to (name of custodian), as custodian for (name of minor) under the South Dakota Uniform Transfers to Minors Act, the following: (insert a description of the custodial property sufficient to identify it)

Dated:

Signature:

(Name of custodian) acknowledges receipt of the property described above as custodian for the minor named above under the South Dakota Uniform Transfers to Minors Act.

Dated:

Signature of Custodian:

What happens to custodial assets when the child becomes 18?
When the child reaches age 18, the custodian is responsible for closing the account. The custodian transfers the property to the child, who can use it in any way he or she chooses. Neither the transferor nor the custodian can place any conditions on the custodial assets once the child reaches age 18.

The financial entity in which the custodial funds have been placed (bank, savings and loan, credit union, mutual fund, brokerage firm) does not keep track of the age of the minor and is not obligated to close the account when the child reaches age 18. That is the responsibility of the custodian. Most account agreements indicate the responsibilities of the financial institutions.

What is the tax effect of a custodianship?
Income Tax. A custodianship is not considered a separate taxpayer. Any income earned, such as interest, dividends or proceeds derived from the custodial property, is taxable to the child. The custodian may use custodial funds to pay any state or federal income tax that is due. Under the “kiddie tax” provisions, unearned income (interest from a certificate of deposit or dividends from stocks) up to $1,600 is taxed as follows:

• The first $800 falls into the child’s zero bracket.
• The next $800 is taxed at a 10% rate.
• Unearned income of more than $1,600 is taxed to the child at the parent’s tax bracket as long as the child is under age 14.
• If the parent is deceased, the “kiddie tax” does not apply. The child would be taxed as an unmarried individual (if such is the case) at the standard rates.

Once the child reaches 14 and has unearned income beyond $1,600, the tax is based on the child’s income tax bracket. These rules are for the 2004 tax year. Check the IRS Form 1040 instructions for the appropriate figure, as it is indexed annually for inflation.

Federal Estate Tax. If you are a parent who is transferring property to an adult custodian such as a grandparent, brother or sister, the value of the transfer amount will not be included in your gross estate for federal estate tax purposes. If, however, you appoint yourself as custodian
and die while serving in this capacity, the value of the custodial property will be included in your gross estate for federal estate calculation purposes.

If your estate value in 2004 is less than $1,500,000, federal estate taxes are not due. If your estate value is over this limit, you may want to appoint another adult or a trust company as a custodian. This will eliminate the value of the custodial property from your gross estate.

**Federal Gift Tax.** When a parent gives a child money, clothing, or other types of personal property, the transfers are ordinarily considered as satisfaction of a parent’s legal obligation of support. If the transfer to the child goes beyond a parent’s legal obligation of support, such as substantial investments or a large amount of money, it will be deemed a gift for federal gift tax purposes.

Gifts of up to $11,000 each year to as many minor children as the transferor wishes may be placed in custodial accounts without triggering federal gift tax liability. For married taxpayers, the annual exclusion is $22,000 to each child, if they make an election to split gifts on a federal gift tax return. If a husband and wife contribute separately to the gift, each can give $11,000 for a total of $22,000 without filing a gift tax return. Married couples who make joint gifts must file a 709 federal gift tax return.

For example, Rod has established custodial accounts for each of his five grandchildren. He plans to transfer $11,000 to each account each year. Rod’s wife, Nora, also plans to transfer $11,000 to each account each year; thus, lowering the value of their estate by $110,000 annually.

There are special rules that apply to gifts of life insurance to a custodianship. The transferor must live three years after making the gift to have the proceeds excluded from the estate.

For example, Fred transferred a life insurance policy with a face value of $250,000, to his minor child in 1999. He died in 2000. The proceeds from the policy ($250,000) were included in Fred’s estate for federal estate tax computation purposes because he did not live three years after the transfer.

**What if I need the money that was transferred to the custodial account early?** You can’t take it back! Your decision is irrevocable. Once assets have been transferred to a custodial account they cannot be taken back. The assets belong to the child.

For example, a parent who established a custodial account for a daughter cannot have access to the funds for any reason – even for an unforeseen family financial emergency, such as a catastrophic illness.

Even if the child wants to give the money back to the transferor, he or she cannot, because the child does not own the account until age 18. Nor, is the custodian allowed to return the funds to the transferor.

**What happens to assets in the custodial account if a child dies before age 18?** If a child dies, the property held in a custodianship becomes a part of the child’s estate. The property is not returned to the transferor, but rather is distributed according to a South Dakota law that provides the disposition of a person’s real and personal property if he or she dies without a written will. Once a child reaches age 18, he or she can have a written will naming individuals to receive his or her assets including those in the custodial account.

If a child is not married (and has no children of his or her own) the property will pass to the parents who will share equally, if both are alive. If only one parent survives, he or she receives the entire amount of the custodial property.

If there is not a valid will and if the parents are not living, then the custodial property passes
equally to brothers and sisters. If any brothers or sisters predeceased the “child” then their descendants (nieces and nephews of the “child”) take the share their parent would have taken.

Payable on death (POD) and transfer on death (TOD) designations are the naming of a beneficiary to receive an account balance on the owner’s death. While South Dakota law allows POD and TOD designations on most financial accounts, these designations cannot be used on custodial accounts.

**What if the custodian dies?**
If the custodian dies before the child reaches the age of 14, and a successor custodian was not previously designated, the conservator for the child becomes the successor custodian. A conservator is an individual appointed by the circuit court to manage assets (other than the assets in a custodial account) left to a child until they reach the age of 18. If the conservator is appointed by the circuit court as custodian, then he or she manages the assets until the child reaches age 18. If the child has no conservator or the conservator declines to act, the following persons may petition the court to designate a successor custodian:

- The transferor
- The legal representative of the transferor
- The legal representative of the custodian
- An adult member of the child’s family
- Any other interested person.

**Does a custodian get paid for managing the account?**
A custodian may annually charge reasonable compensation for services performed, unless the custodian is also the transferor of the property. The custodian is also entitled to reimbursement for reasonable expenses incurred for services performed.

If a friend or relative is named as custodian, the custodian’s compensation can be fixed in advance. By separate agreement, the transferor can provide that the custodian will receive a fixed annual fee or an annual fee that is a specified percentage of the value of the custodial assets. Trust companies generally have rate scales for computing compensation based on the value of the custodial property. Two advantages of naming a trust company as custodian are professional management and impartial distribution of the custodial assets.

**What if the custodian is not managing the property effectively?**
A transferor, the legal representative of a transferor, an adult member of the minor’s family, a guardian of the person of the minor, the conservator of the minor, or the minor if the minor has attained the age of fourteen years may petition the court to remove the custodian and to designate a successor custodian other than a transferor, or may petition to require the custodian to give appropriate bond, if the custodian is not properly fulfilling his or her custodial duties.

**What is the impact of custodial accounts on my child’s eligibility for college financial aid?**
Financial aid formulas require that 35% of a student’s assets be counted towards college costs before a family qualifies for financial aid. Parents are expected to count only up to 12% of assets in their names. Custodial accounts are counted as a student’s assets because the income from the account is reported under the social security number of the child.

Congress is considering new financial-aid formulas that would combine the student’s and parents’ assets and assess them at the same rate. Such a change would eliminate entirely the financial-aid-based argument against saving for college in a custodial account that has been the “rule” in past years.

**Summary**
Before you set up a custodial account for a minor child, carefully consider your objectives and other ways you may achieve them. You may find that for educational purposes, an education
Individual Retirement Account (IRA), regular IRA or a Roth IRA may be better choices. Another possibility is to set up a trust naming a trustee to manage assets for a child.

Consult an estate planning or tax attorney, certified public accountant, or other financial planning professional for specific legal and tax implications of these alternatives.

References


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