An account set up under the Uniform Gift to Minors Act (UGMA) or Uniform Transfer to Minor Act (UTMA) is an irrevocable gift made to a minor child. The custodian of the account, usually the parent, controls the money until the minor reaches the age of majority (18 or 21 in most states). At that time the account becomes the legal property of the child.

Changes in the 2006 Tax Law made Custodial Accounts less attractive by raising the age limit of the so-called kiddie tax. This means that investment income earned is taxed at the parents’ rate and not the child’s rate. Previously the kiddie tax provision applied to children under the age of 14. Now the kiddie tax is imposed on children under the age of 18. (Beginning January 2008 the “kiddie tax” will have a wider reach by extending the age to 23. Students who have investment income above $1,700 who do not provide more than half of their own support, will be subject to tax at their parents’ rate.)

- Income earned in a custodial account is taxed first to the child and then to the parent when the income goes above $1,700. For the dependent, the first $850 of investment income is tax free. Through the end of 2006, for dependents under age 18, investment income from $850 to $1,700 is taxed at 5 percent, the tax rate for dividends and capital gains, or at 10 percent for interest income. Over $1,700 is taxed at the parents’ highest marginal tax rate. Once a child is 18, income over $850 is taxed at the child’s rate. In 2007 the kiddie tax will extend up to age 23 for those students who are not providing more than half of their own support.

- Individuals can gift up to $12,000 a year to a child, or $24,000 a year if parents make a split gift, without paying gift tax.

**Advantages**

- Custodial accounts are easy to set up with banks or brokers and can be funded with cash, bonds or stocks, and mutual funds. (UTMA accounts allow real estate.)

- There is no penalty if funds are used on behalf of the child for noneeducational expenses.

- Custodial accounts used to be popular gifting strategies. Families could lower overall taxes by giving investments to children no longer in the “kiddie tax” age range. If parents are in the 25 percent tax bracket or higher, there is a tax savings when you shift assets to a child in a lower tax bracket. When the child sells the assets, the tax savings can be used for the child’s education. This so-called income shifting used to provide tax savings to children 14 and older, but now applies to those 18 or older. In 2008 this strategy will not work for students 23 or younger who are still dependent on their families for more than half their support.

- Many mutual fund companies have low minimum purchase requirements for UGMA accounts. It’s a great vehicle for grandparents who want to make college gifts at birthdays.

**Disadvantages**

- You need to wait until children are 18 to sell appreciated stock funds in a custodial account, or the gain will be taxed at the parents’ rate. (In January 2008, the age will increase to 24 for students dependent on their families’ financial support.)

- Once children reach the age of majority, the funds become their property and can be used for purposes other than college.

- Assets held in custodial accounts will limit a student’s eligibility for financial aid.
Best Use for College Savings

Assets held in a custodial account can be used at the discretion of the parent on behalf of the student. The parent maintains investment control. For parents of students age 18 or older who set up custodial accounts to take advantage of lower taxes, they may wish to sell appreciated assets before the end of 2007. The proceeds will be taxed at the student rate (as low as 5% for qualified capital gains.) In January 2008, the gains will be taxed at the parents’ rate if higher than the rate of the student.