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Guest Article

How To Advise Clients With Maturing UTMA Accounts

By Jeffrey A. Baskies

How often do we hear this same story: I set up a UTMA for my child ages ago, it has appreciated significantly, now the child is about to turn 21 and he can't manage that kind of money. What do I do?

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This is a very common refrain. Clients created UTMA (Uniform Transfer To Minors) accounts and funded them (or had relatives fund them) many years ago. With the stock market increases over the past 20 years (which are significant despite the market corrections), many of these accounts have grown to significant value.

At the same time, their children are now "adults," but the clients are not satisfied they can handle significant wealth. Who would be? Most 21 year olds are still in college and have had neither the reason nor the opportunity to show a propensity to manage significant sums of money.

The impact of realizing substantial wealth will potentially pass into the hands of their 21-year-old children can be quite extreme. Shock, horror and sheer upset are common reactions among clients.

Below, I will address some of the more common and basic issues and approaches.

First Response: Understand The Basic Duties

Our first response inevitably is to advise our clients of the obligations placed upon them acting as fiduciaries under an agreement (the UTMA agreement). They took on a fiduciary duty and that holds serious consequences. Some planners undoubtedly even quote famous lines on fiduciary duty like Chief Judge Benjamin Cardozo's bit on the "punctilio of an honor":

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

Meinhard v. Salmon, 249 N.Y. 458, 464 (1928)

Once done with the speech on fiduciary duty, we then often advise our clients that to breach that duty would expose themselves to a potential lawsuit from their child.

And what is the duty owed? In this case, the duty of a fiduciary of a UTMA is to deliver the funds to the child after the child reaches the age of 21. So there is a constant conflict between the clients' duty and the clients' preferences.

As valued advisers and effective attorneys, we owe it to our clients to remind them of these basic rules. The fiduciary duty of a custodian, the legal obligation to deliver the funds, and the consequences of a breach of such duty are all necessary elements of any discussion on this subject.

Second Response: The Options

Just because a client has a duty to turn over the funds in the UTMA at age 21, doesn't mean the client is without options. There are some very basic and traditional approaches as well as some more complex ways to deal with this dilemma.

- **Spend Down**

One rather simple option is to spend the money (or at least some of it) before the child reaches the age of 21. For example, if there is a good reason to fear how the child would manage the funds, then they could be used to pay for a year or more of college tuition and other college expenses.

Using the funds to pay for college might diminish the value of the UTMA rather quickly. In every jurisdiction the custodian of UTMA accounts has the ability to use the funds for a child's education, so this should be an uncontroversial means to diminish the size of the account.

However, many parents funded UTMAs but also planned to pay for their children's college education. It may seem unfair to a child (particularly if there are several children) if one child's entire college were paid by the parents while another had to "partially self-fund" college by having his UTMA utilized. Such interfamily emotions are significant issues and should be explored.

College education is not the only means to spend down a UTMA but it is one fairly obvious and substantial one. Others obviously exist - like paying for a child's health care needs (if relevant) or living expenses, etc.

The biggest problem with this approach is many UTMA accounts are just too big to be spent down.

- **Pass Legal Title but Keep the Assets Invested with a Friendly Adviser**

A second old-school option is to give the money to the child but with some "strings" attached.

For example, the custodian is willing to turn the assets over to the child, but "insists" the child meet with the financial adviser who has handled the investments for many years and who will

undoubtedly continue to do so. By keeping the money in the hands of an adviser the parents trust, they may feel more comfortable turning over legal title to the child.

This approach works pretty well in families where wealth has been rather freely discussed and the children have been involved in investment planning. Moreover, if the child already knows and trusts the financial adviser, this plan has a chance of being quite successful. While not every family is comfortable involving children in investing that way, some families do share those topics and this approach seems to work well for children with a level of financial "maturity."

The biggest downside to this approach is not every child is mature enough to be trusted and, once the child has legal title, the financial adviser cannot legally stop the child from moving the money and "blowing" it however he wants.

- **The "Walk-Around-the-Block" Trust**

A more sophisticated way to pass the UTMA assets to the child while retaining strings on the money is to actually convince the child to put the funds he receives from the UTMA into a trust for his own benefit.

Some planners have called this the "walk-around-the-block" trust. The term comes from the image of some uncle or other trusted family adviser taking the soon to be 21-year-old out for a nice long walk around the block. During that stroll the child is convinced of the virtue of taking all the assets he will soon receive from his UTMA and placing it into a trust for his own benefit. I have an image of Don Corleone making the poor kid "an offer he can't refuse."

Anyway, with this method, the assets are turned over to the child so the custodian's duty is fulfilled. However, usually prior to the child turning 21, he calls you to set a meeting at which time he wants to discuss with you his ability to create a trust for his own benefit - but which will be managed by his mother or father. The trust, the child tells you, is necessary to protect him and the assets.

If the family has done a good job of convincing the child that he needs this trust, the planning is rather simple. All that you need to figure out is who should manage the assets (primary and secondary trustees) and under what circumstances should the assets be made available to the child. Finally, a typical "walk-around-the-block" trust does not last for a lifetime, so the ages for distribution (rights to withdraw at 30/35/40 are common) should also be considered.

If real asset protection is desired, then the clients should consider setting up the trusts in one of the states that recognize self-settled trusts (Delaware and Nevada for example). Otherwise, as they are self-settled trusts, the funds in the trust are likely going to be available if an aggressive creditor seeks to attach them. But for many clients, real asset protection isn't the purpose of the trust. Many clients want these trusts just to ensure the 21-year-old child won't squander the assets and are not concerned for sophisticated creditor protection planning. So the trusts may be established where the children and/or parents live.

One potential pitfall with this planning is the child could take the assets and not fund the trust. But usually the chances of such are very remote as the convincing arguments are made right up front. Moreover, most often the not-so-veiled threat behind these arrangements is "if you don't comply with this request on the UTMA you may lose out on a much bigger inheritance." Such potential lost wealth may assure compliance.

- **Tie up the Investments in a FLP**

Another option for the custodian (albeit the one with the greatest risk) is to invest in an asset that cannot be easily liquidated. For example, the custodian may invest UTMA assets in a family limited partnership ("FLP"). The FLP may have restrictions on withdrawal and liquidation (as well as on sale) so as to make it virtually impossible for the child (once he reaches 21 and is given

his interest as a limited partner) to waste the assets.

One of the benefits of this type of planning is there is not period where the child can change his mind and take off with the money. The investment in the UTMA is made prior to the child reaching 21, so at that time, the asset the child gets is already restricted.

Another benefit of this type of planning is the opportunity to shift wealth at discounted values. Many clients have FLPs that they use for family wealth shifting purposes. If a child's UTMA has significant assets, then a sizable fraction of the FLP may be transferred to that generation at a discounted value. This technique works particularly well where the UTMA has cash, so there are no issues of capital gains for the child on buying an interest in or making a contribution to the FLP (the investment company rules).

Even if some gains are necessary, the opportunity to shift wealth at a discount coupled with the chance to tie up the child's assets on the expiration of the UTMA may make paying some current tax palatable.

One of the problems with this kind of planning is, if the family does not already have an FLP to use for this opportunity, it can be expensive to create one. However, if there are good reasons for the family to have an FLP, then this is money well spent.

Another potential problem with this planning is the risk of suit by the child. A custodian of a UTMA has a duty to the child and a child may argue that duty may have been breached upon fully investing all the assets into a FLP. First, there is an obvious lack of diversification in the UTMA portfolio of the only asset is an interest in an FLP; however, if the FLP itself is well diversified, that may mediate against this argument. Second, though, the child may argue that the custodian breached his duty to protect the assets for the child by investing in a vehicle where the assets are now subject to the control of someone else - the general partner - and all sorts of restrictions on marketability.

To date, I have not heard of a successful suit on these grounds, but we can imagine an aggrieved child someday might try it.

- **Transfer Assets to a 529 Plan**

Recently I have heard some custodians have taken a new and at least to me a controversial tact - transferring the funds to a 529 plan.

529 plans are college savings programs with special governmental tax breaks. They can exist beyond a child's 21st birthday and if not used for that child's education, they can instead be used for another child's. Moreover, the owner of the 529 plan can withdraw the funds - subject to certain penalties.

I'm not certain that this is legal at all. First, the custodian of a UTMA cannot use the UTMA assets for the benefit of any of the child's siblings or anyone else for that matter. Second, the custodian of a UTMA cannot take the funds back out and use them for himself.

So at least at some level, the options available to a custodian in a 529 plan are incompatible with the options afforded a custodian of a UTMA. And it would appear to risk breaching the custodian's duty under the UTMA to transfer the funds.

However, this issue is relatively new and I've only recently begun hearing of this planning technique. So it may not be widespread at all - or there may be some argument available that moving the funds is not a breach. I'm just not familiar with them, so I'd caution planners about advising clients in this regard.

Conclusion

UTMAs have been very successful and popular vehicles for managing wealth for minors. As the size of these accounts has grown, so too have the issues of what to do with them as the minors are maturing (at least age-wise).

Unfortunately, these accounts have created a great deal of consternation for many of our clients. The clients are often faced with conflicting duties on the one hand to turn over the assets to the child at age 21 and on the other to fulfill their parental obligation to protect the child and ensure that he isn't harmed (including by himself).

Above are some common approaches to the problems. You probably have similar stories and more interesting cases. Feel free to share with us so everyone will benefit.

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