

# Should Clients Use a CUTMA Account to Save for their Children's Education?

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Planning for a child's education expenses often involves creating a segregated fund for that use. A common vehicle for holding the segregated fund is a custodial account under the California Uniform Transfers to Minors Act (CUTMA). Although creating a CUTMA account is simple, its use may not yield the desired benefits.

## Understanding CUTMA

CUTMA provisions are set forth in California Probate Code Sections 3900 through 3925 and dictate fairly inflexible rules regarding the duties and powers of the custodian. Before serving as custodian, it's important to review the CUTMA rules, particularly the following:

1. A CUTMA account can only benefit one child and may have only one custodian.
2. In managing the CUTMA assets, a custodian must invest the assets in the manner in which a prudent person would invest the assets. The prudent person rule emphasizes safe investment of each asset (compare to the Prudent Investor Act, which balances minimization of risk with maximization of return done on a portfolio-wide basis).
3. If a custodian is not compensated, his or her liability will be limited to harm resulting from bad faith, intentional wrongdoing, or gross negligence.
4. A custodian may pay to the child, or expend for the child's benefit, as much of the CUTMA assets as the custodian considers advisable for the use and benefit of the child without regard to

(1) the duty of the custodian or any other person to support the child or (2) any other available income or property of the child.

5. Custodianship terminates upon the child's 18th birthday, unless the document creating the custodianship provides for a longer term. The maximum term for a custodianship created by a lifetime gift is the child's 21st birthday. The maximum term for a custodianship created pursuant to the terms of a trust or will is the child's 25th birthday.

## CUTMA Difficulties

The following problems may arise from use of a CUTMA account:

1. Upon the child receiving custodianship property at age 18 or 21, the child may expend the funds for any purpose, educational or otherwise. In addition to loss of funds intended for college, the availability of substantial spending money may divert the child's attention from education.
2. Until the child is 15, income generated by the CUTMA assets will be taxed at the parents' highest marginal income tax rate pursuant to the "Kiddie Tax."
3. A CUTMA transfer by the parents to either parent as custodian does not qualify as a completed gift, and therefore does not decrease the parents' estate for estate tax purposes.
4. Availability of a child's custodianship funds may cause ineligibility for certain scholarships and student loans.
5. CUTMA transfers are irrevocable. Parents who worry that a child will not be mature enough at the termination of

the custodianship at age 18 or 21 may be helpless to deny the child's access to the funds.

## Alternatives to CUTMA Transfers

While creating a CUTMA account with a termination age of 21 (rather than 18) reduces the early distribution problem, the following alternatives to CUTMA accounts may be more effective in achieving the clients' goals:

### Irrevocable Trust

- **Benefits:** Trust funds can be controlled until any age; they can provide educational incentives; provides flexibility in the investment of assets.
- **Negatives:** Tax returns are required (and trust income is likely to be taxed in a higher bracket than if taxed at an individual tax bracket); trust funds are likely to be counted in determining eligibility for scholarships; cost of trust creation; the transfers to the trust are irrevocable.

### Scholarshare

This is a new program provided by the state of California (similar programs have been adopted by many other states).

- **Benefits:** Income tax deferral; gift tax savings; transfers to Scholarshare accounts are treated as irrevocable for estate tax purposes (i.e., treated as a completed gift) but can be reversed with a small penalty.
- **Negatives:** May hurt eligibility for scholarships; parents lose control of investments.

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## CUTMA

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### Parents Retain Funds

- **Benefits:** Simplicity; reduced net worth of child may qualify child for more scholarships.
- **Negatives:** No income or estate tax benefits; parents may dip into the "cookie jar."

### Alternatives for Existing CUTMA Accounts

If a parent is worried that a child will squander CUTMA assets, the parent could invest the assets in a manner that renders the assets unavailable for expenditure, such as transferring the CUTMA's investments into a family entity (a family limited partnership, LLC, and so on) in exchange for noncontrolling interests in the entity.

Because the assets would then be held in an entity that does not have to distribute income, the child would have no expendable income unless the parent made a distribution from the entity. The child's income may be reduced, because of the parents' control of the entity, and his or her and total assets may decrease as the result of the valuation discount applicable to a fractional interest investment in a closely held entity. These two reductions may result in increased eligibility for scholarships.

The downside to investment in a closely held entity is that because the custodian

must preserve the value of the investment under the prudent person rule, the child could bring an action against the parent for the diminution in the value of the CUTMA assets as a result of the fractional interest discount (because of difficulty in selling a fractional interest in an entity, and because the investment is a non-controlling interest). Consider this risk with the assistance of counsel before investing a child's assets in any restrictive investment.

Instead of transferring the CUTMA assets to a restrictive entity, the parents may decide to wait until after the CUTMA term, at a time when the parents may still have significant influence over the child. The child may then be convinced to transfer the asset to a trust or other arrangement wherein the parents are confident the assets will be properly used.

As with any other investment, doing the research on CUTMA up front will minimize potential damage after the fact.

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## VALUATIONS

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first appraisal, the minority shareholders got a second appraisal, which determined that the market value of the smaller MSO was nearly double the first appraisal.

It was finally agreed that the value of the minority shares was \$950,000.

**Lesson learned:** It isn't sufficient to state an amount that a buyer is willing to pay for your practice. How much are other buyers willing to pay for your practice? Fair market value is the amount agreed upon between a willing buyer and a willing seller, both having knowledge of all relevant facts, and neither being under any compulsion to buy or sell.

### Conclusion

Any appraisal of a practice should utilize several methods to create a range of values that provides a reality check for the conclusion. Your clients may have an idea of what it would cost to create their practice today, and what practices like theirs are selling for. But in the final analysis, if they are not satisfied with a potential acquirer's valuation of their practice, it may be prudent to advise them to hire an appraiser and get a second opinion on the value of their practice.

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## Email List

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mittee; Senate and Assembly: Judiciary, and Revenue and Taxation.

CalCPA members have met with 22 legislators since April and seven meetings are scheduled. Even if your legislators do not serve on these committees, it is important

that they meet with their CPAs during the interim. If you want to participate by helping to organize a meeting in your area, call Demetre Paraskevas at (916) 441-5351 for tips on setting up a meeting and to obtain talking points on current issues for these meetings.

**Make up your mind early, the Primary is in March!**

The final closing date for candidates running for Assembly and Senate in next year's March primary is November 10.

If you have a particularly hot candidate you are supporting, let us know. It is time to begin planning chapter candidate events and volunteering for campaigns. If you need help, give us a call, at (916) 441-5351.