The Uniform Transfers to Minors Act: Extending the Period of Protection

by James R. Wade

This column is sponsored by the CBA Trust and Estate Section. The column focuses on trusts and estate law topics, including estate and trust planning and administration, elder law, probate litigation, guardianships and conservatorships, and tax planning.

This article provides a brief overview of breach of fiduciary duty issues that may arise when the custodian of an UTMA account or the trustee of a 2503(c) trust transfers assets into a family partnership as a means of extending asset protection.

This article presents an alternative perspective to a portion of the topic discussed in the "Estate and Trust Forum" article in the November 2005 issue of *The Colorado Lawyer*. "Retaining Control of Gifts to Minors: UTMA and IRC 2503(c) Trust Options,"[1] written by Constance D. Smith, provided an overview of accounts created pursuant to the Uniform Transfers to Minors Act ("UTMA")[2] and Internal Revenue Code ("IRC" or "Code") § 2503(c) trusts,[3] and discussed steps parents, donors, custodians, and trustees could take to provide continued asset protection after the beneficiary reaches the age of 21 and the account or trust terminates.

The November article included a discussion of a difficult issue that often arises in practice: What to do about assets held in trust when there is concern about the maturity and reliability of the beneficiary who is about to reach the age of 21.[4] One of the techniques suggested is having the trustee, prior to the beneficiary's twenty-first birthday, transfer the trust assets to a family partnership in exchange for an interest in that partnership. The effect of this may be to convert what otherwise would be a liquid present interest in an asset to an illiquid, perhaps fractional, interest in an entity that may have a lengthy duration.

Whether there are potential breach of fiduciary issues when a custodian or trustee engages in such a course of action is a matter of some debate. This article provides a different perspective to that presented in the November article and discusses the fiduciary issues that may arise when account assets are transferred to an interest in a family partnership.[5]

UTMA Accounts and 2503(c) Trusts

UTMA accounts are one of several devices commonly used to make gifts to minors and simultaneously allow the donor to qualify for the federal gift tax exclusion. Under UTMA, donors may create a kind of statutory account, which allows the gifted funds to be invested, accumulated, and distributed to or for the benefit of the minor beneficiary before he or she reaches the specified age, which is normally 18 or 21.[6]

An alternative to UTMA accounts is the use of IRC § 2503(c) trusts. A 2503(c) trust is an individually drafted trust established for the sole benefit of a minor. This device also qualifies for federal gift tax exclusion treatment and must terminate when the beneficiary turns 21.

There are some differences between UTMA accounts and 2503(c) trusts. An UTMA account is, for income tax purposes, considered the alter ego of the minor, and the income is taxed under the minor's own personal social security number.[7] A § 2503(c) trust is a separate tax-paying entity with its own taxpayer identification number.[8] Also, if the minor beneficiary has a one-time withdrawal power over all assets of the 2503(c) trust

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at age 21, and does not exercise that power, the trust may provide that it will continue until some later age of the beneficiary.[9] An UTMA account cannot be so extended.

Transfers to Family Partnerships

From time to time, the question arises as to whether there are ways of extending the protection of account or trust assets, most often when the donor, often a parent or grandparent, has second thoughts about the maturity and responsibility of the young adult who is to receive the funds outright when reaching the age of 21.[10] One technique for providing continued asset protection is for the custodian or trustee to create a family limited partnership or limited liability company[11] and transfer the account or trust property to the new entity in exchange for units of ownership in the new entity. The custodian, trustee, or another party designated would control the new entity. The members of the entity would have limited rights to withdraw assets or terminate the entity, and the entity could continue for many years. The practical effect of such an arrangement would be to extend the period of asset protection for a number of years beyond the date when the account or trust otherwise would terminate.[12]

A rationale for this approach is often based on the language of the Uniform Custodial Trust Act ("Uniform Act"),[13] which gives the custodian broad powers to manage and invest custodial property. The original version of the Uniform Act was the Uniform Gift to Minors Act ("UGMA"), which was adopted by the Conference Commissioners on Uniform State Laws ("Conference") in 1956. In 1965 and 1966, the Conference revised UGMA to broaden the kinds of property that could be transferred into an UGMA account, and to allow a broader range of fiduciary investments.

These earlier statutes provided a "laundry list" of fiduciary powers, which arguably included the power to acquire partnership interests. The theory was that because partnership interests were listed as permissible holdings, obtaining such interests was permitted. In 1986, the Conference revised the Uniform Act and titled it the "Uniform Transfers to Minors Act." The UTMA section regarding powers of custodians provides: "A custodian acting in the custodial capacity, has all of the rights, powers and authority over custodial property that unmarried adult owners have over their own property, but a custodian may exercise those rights, powers and authority in that capacity only."[14]

What is critical, however, is the following section, which provides: "This section does not relieve a custodian from liability for breach of section 11-50-113." That section, dealing with care of custodial property, provides:

> In dealing with custodial property, a custodian shall observe the standard of care that would be observed by a prudent person dealing with the property of another and is not limited by any other statute restricting investments by fiduciaries. If a custodian has a special skill or expertise or is named custodian on the basis of representations of a special skill or expertise, the custodian shall use that skill or expertise.[15]

The essence of this provision is that a custodian is a fiduciary and that the exercise of custodial powers must be in a fiduciary capacity, subject to fiduciary standards.

This provision is consistent with traditional trust law.[16] The traditional primary duties of a fiduciary are: (1) the duty of care or prudence; (2) the duty of undivided loyalty; and (3) the duty of impartiality. The fiduciary standard under UTMA parallels the Uniform Probate Code[17] and states the standard for the custodian's duty of care or prudence.

The transfer of a property interest that the beneficiary otherwise would receive at the age of 21 into a family partnership or other entity creates several problems in connection with the custodian's duty of care and prudence. Initially, the transfer would deprive the minor of the benefit of outright ownership and control of property interest, apparently contrary to the policy of UTMA, which provides for termination at the age of 21.

Also, the transfer would violate the narrower common law rule against a trustee burdening trust property interests in a manner that extends beyond the time period for termination of the trust. When considering such a transfer, the custodian should consider: (1) the probable duration of the trust; (2) the length of the term of the investment, for example the maturity date if any, or the callability or redeemability, if any; and (3) the marketability of the particular investment.[18] When the trust will terminate on a certain date, the custodian generally should not transfer the trust assets to a vehicle that cannot be converted to cash on the termination date.[19] When the trust will terminate in a short period of time, such as within one or two years, the trustee should not transfer the funds into a long-term investment, such as a mortgage; however, investing in marketable, long-term bonds likely is acceptable because they could be sold and thus can be easily converted to cash.[20]

The transfer of assets to a family partnership or other entity would, in effect, destroy the marketability or alienability of the beneficiary's interest. For example, if UTMA or 2503(c) trust assets that were contributed to the new entity were marketable stocks and bonds, the beneficiary would end up with a non-controlling, possibly minority interest in a new entity. Such an interest is unlike, for example, a real property interest, which is partitionable or saleable, and virtually every state provides a statutory partition remedy in connection with undivided interests in real estate. An interest in a family partnership is not partitionable or saleable, and the custodian's transfer of marketable assets into a fractional, non-marketable interest in an entity may be contrary to the policy in favor of maximum alienability and marketability of property interests.

Often, the motivation for the custodian's transfer of assets to a family entity is the desire for continued control of the assets on the part of the trustee, donors, or other family members. These individuals may have their own ideas as to how the property should be managed in the long run, even after the beneficiary reaches the age of 21, ostensibly for the benefit of the beneficiary. Arguably, this is contrary to the custodian's duty of undivided loyalty to the beneficiary.

The general policy of the law in Colorado appears to indicate a preference for outright ownership of interests in property and free alienability or transferability of such interests. For example, Colorado statutory partition law allows the owner of a fractional interest in property, including the owner of a minority interest, to bring a statutory action to partition or divide the property so that the concerned owner may have an outright ownership interest.[21] Often, where the property cannot easily be divided, the property will be sold by a commissioner or commissioners in partition and the proceeds from the sale will be divided among the owners. In the probate context, this partition right is included among the distributive powers of the personal representative of an estate; the personal representative may partition or physically divide property in connection with the distribution of an estate.[22]

Creating a New Entity

In 2002, the Colorado legislature enacted CRS § 15-1-702, which provides, in part:

> (2) Any fiduciary acting under a will or trust instrument that evidences an intent to retain an interest in a family business may maintain the interest in any form of entity or successor entity. Such a successor entity may be formed by consolidation, merger, acquisition, or other combination and shall be considered the same enterprise for purposes of maintaining the interest in the family business where the interests of the beneficiaries in the successor entity are substantial.

(3) Except as otherwise provided in the instrument under which the fiduciary is acting:

(a) A fiduciary may proceed as provided in this subsection (3) with the formation of such a successor entity where the fiduciary believes in good faith that the formation is on a favorable basis considering only the overall interests of the beneficiaries including the maintenance of a substantial interest on the part of the beneficiaries in the enterprise and the value of such interest in the long term. . . .

This statute requires notice and court order to create such an entity. It also requires the existence of a family-owned business or enterprise and a finding that the testator or settlor intended that the family business or enterprise continue in operation. The court must, in effect, find that a benefit will result from continuity or creation of control that outweighs the harm to the beneficiary that will result from the loss of control over and transferability of assets upon termination of the account or trust.

Although this probate statute does not specifically apply to UTMA accounts or 2503(c) trusts, the policy considerations are the same. Courts might consider it by analogy when deciding cases where a custodian or trustee transfers account or trust assets to an entity such as a family limited partnership.

Remedies

In the event the beneficiary prevails in an action against the custodian or trustee for breach of fiduciary duty, several remedies are available, including removal and surcharge. The surcharge remedy may involve the payment of damages by the custodian or trustee from his or her individual assets to compensate the beneficiary for damages.[23]

Other Options for Extending Control

When continued asset protection is desired, several options are available to custodians, trustees, donors, and family members. Which option is best in a given situation will depend on the extent of the beneficiary's limitations. One approach is simply to do nothing and continue with the *status quo* beyond the beneficiary's twenty-first birthday. However, failing to advise the young adult of his or her rights on termination of the account or trust presents several problems. Unless the custodian or trustee also prepares the beneficiary's income tax returns and has authority to sign them, the beneficiary likely will be alerted that these assets exist when he or she reviews and signs the income tax returns. This "benign neglect" approach also postpones the inevitable day of accountability to the beneficiary and can be considered a breach of fiduciary duty.

Another approach is similar to the method of extending a 2503(c) trust. The custodian or trustee can obtain the beneficiary's consent to continued management of the assets, perhaps in the form of a new revocable trust with restrictions.

If the beneficiary has a serious disability that would meet the criteria for the appointment of a conservator under the state's protective proceeding statute,[24] the custodian, trustee, or other interested person could petition the court for the establishment of a conservatorship or other protective arrangement. An interested party could request the court not to impose a full, plenary custodianship, but rather to approve a single transaction that could be tailored to extend the period of the custodial trust protection for an additional term of years.[25]

Conclusion

The transfer of custodial trust assets in exchange for an interest in a family entity also is discussed in several other articles, most of which take the general approach that if nothing is ventured, nothing is gained in connection with the conversion of the custodial trust asset into a family entity unit. The general consensus is that, although such transfers may not be strictly permissible under state law, it is likely that the beneficiary may not be aware of the transfer of assets and may not complain and that, in the worst case, the transaction simply may be invalidated. However, serious breach of fiduciary duty issues may arise when a custodian or trustee transfers account or trust assets to a family partnership interest.

NOTES

1. Smith, "Retaining Control of Gifts to Minors: UTMA and IRC 2503(c) Trust Options," 34 *The Colorado Lawyer* 39 (Nov. 2005).
2. CRS §§ 11-50-101 *et seq.*
3. IRC § 2503(c).
4. Smith, *supra*, note 1 at 46.
5. A version of this article was presented as a memorandum to the Elder Law Committee of the American College of Trust and Estate Counsel in January 2005.
6. Although the state law age of majority is 18, for the purpose of this article, the termination of the custodian protection occurs at age 21.
7. *See* Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts*, Vol. 3, § 75.4.4 (Boston, MA: Warren, Gorham & Lamont, 1999).
8. *See* IRS, Instructions for form SS-4 (Rev. Sept. 2003), available at http://www.irs.gov/instructions/iss4/ch01.html.
9. Rev. Rul. 74-43, 1974-1.
10. *See* Geer, "When Taking Candy from Babies Makes Sense," *Fortune* (April 3, 2000).
11. *See* CRS §§ 7-60-144 and 7-64-1002; CRS §§ 7-80-101 *et seq.*
12. Blattmachr, *Wealth Preservation and Protection for Closely-Held Business Owners (and Others)* at 462 (Lanham, MD: Nat'l Book Network, 1993).
13. CRS §§ 15-1.5-101 *et seq.*
14. CRS § 11-50-114(1).
15. CRS § 11-50-113(2).
16. *See, e.g.*, § 16, Comment b of the *Restatement of Trust 2d*; *Restatement of Trust 3rd* (tentative draft 2004), § 1, Comment a and "Reporter's Notes." *See also* § 5, Comment a(1).
17. CRS § 11-50-113(2).
18. Ascher, *et al.*, *Scott on Trusts* § 227.12 (New York, NY: Aspen Pub., 4th Ed.), *citing Restatement of Trusts, 2d*.
19. *Id.*
20. *Id.*
21. *See* CRS §§ 38-28-101 *et seq.*
22. CRS § 15-12-911.
23. *See Buder v. Sartore*, 774 P.2d 1383 (Colo. 1989).
24. *See* CRS 15-14-401.
25. CRS § 15-14-412. ■