Trust, 529 Plan, or Custodial Account: Which is Best for Your Young Child

When a child is born, their health and happiness comes first. As the years pass and school starts, you might also be wondering: What types of financial accounts can best prepare them for what lies ahead in life?

For families with significant wealth, funding their children's needs is usually not an issue. But HOW you provide the funds is worth thinking about carefully.

We have seen that financial accounts can be used strategically to educate, motivate and support the younger generations within families, setting them up for success later in life.

The two most common hurdles to funding accounts for children are not high, and they can be easily overcome if you know the advantages that await on the other side:

1. **Concern about the loss of control over the funds and the child's privacy.** Banks require a child's Social Security number to set up an account. This drives many parents/grandparents to use their own accounts and earmark funds for children within those. But co-mingled funds not in the child's name lose effectiveness as teaching and motivating tools.
2. **Indecisiveness.** There are many types of accounts out there, so which is best? We typically advise LNW clients to use more than one kind if that helps them reach various goals. Each of the different account options makes sense for different reasons.

The following is a quick summary of different account types for young people. Again, these are not mutually exclusive. In fact, some families use all three types for different reasons.

Custodial Accounts (UTMAs/UTGAs): Financial Training Wheels

Ease of setup and usefulness as a teaching tool. Custodial accounts are opened much like an individual bank or investment account, except that an adult custodian needs to be on the account until the child reaches the age of "financial majority," which is 18 or 21, depending on the state of residency.

Often, parents and grandparents fund these types of accounts up to a point where the windfall would not be considered overwhelming at age 18 or 21. Also, access while young need not be a drawback if the child has been involved in monitoring and managing the account all along the way with the parents' help.

How you fund a custodial account can evolve over time as children age and learn. Starting out, these accounts can mostly hold the child's money – holiday and birthday gifts, allowances, wages from a summer job. This opens up possibilities to discuss with them how to save, invest and donate money to what they're passionate about and to balance out the tendencies of their money personalities.

As young people show interest and aptitude, you can consider transferring increasing amounts of assets into the account. At that point, some families encourage the children to set up their own relationship with the LNW advisory team. In this way, custodial accounts can build the confidence, know-how and relationships needed to later manage a significant inheritance or some or all of the family estate.

	Trusts	Custodial Accounts (UTMA/UTGA)	529 Plans
Setup	Requires a legal trust document and account opening	Simple application and account opening at a financial institution or investment firm	Simple application and account opening. Plans are sponsored by individual states
Costs	Setup costs and ongoing trustee/administration and investment costs, including annual tax return filing	Little to no setup costs, but ongoing maintenance/investment costs depending on financial institution	Typically maintenance, administration and investment costs (vary depending on sponsoring state)
Control	Trustee has control (parent should not be trustee) and corporate trustee is recommended	Custodian could be parent, although that would include the accounts in their estate	Owner can be parent or grandparent and account would not be included in their estate in most cases
Investment Choices	Flexible	Flexible	Limited to options in particular state plan
Age of Distribution	Flexible, with age for distributions specified in trust document	18 or 21 depending on the state (there is an "age 25 UTMA" option but annual exclusion gifting ability is lost)	Varies depending on the state sponsoring the plan
Income Tax Benefits	Generally no (estate taxes may be reduced depending on type of trust)	No (but can benefit from capital gains tax, which is lower than tax on income)	Yes, grows tax-free and distributions are tax-free if used for qualified expenses*
Distribution Terms	Determined by trust document, can provide a flexible definition for education	Limited: Only the Custodian can withdraw funds for the child's costs, but at age 18 or 21 (or 25 if elected) the account is controlled by the child	Qualified higher education expenses including college tuition, room, board, fees, books. Up to $10,000 per beneficiary per year can be distributed for K-12 enrollment or tuition

*Certain rollovers from a 529 Plan to a Roth IRA for the same beneficiary can be qualified distributions under federal tax law.

529 Savings Plans: Education Is the Focus

Tax-advantaged investment in education. Saving for K-12 and college can be prioritized by opening and funding a 529 Plan, of which there are two types – education *savings* plans (most flexibility) and *prepaid tuition* plans.

Why a 529 Plan if you can just pay for college out of pocket? For one, a 529 plants a flag for the family around education. Even during grade school, children can know that education is a family priority, and they can even be involved in tracking the 529 Plan and its holdings. As young people start to think about what to do after high school, you can discuss with them how money from the 529 can pay for the type of education they are considering, not only college and graduate school but also vocational, technical or trade schools.

A 529 Savings Plan, in particular, offers substantial tax savings over time as well as flexibility. Once the account is funded with after-tax dollars, the assets can grow without being taxed annually at the federal level and sometimes also at the state level. Withdrawals would not be taxed if they are used to pay for qualified education expenses, including up to $10,000 annually for grade school and high school. Otherwise, there's a 10% penalty on the portion that is not principal (the income and capital gains), which would be taxed as income.

We often help clients decide which 529 Savings Plan to invest in, since all 50 states now offer them and you can invest in any of these regardless of where you live. We also advise on whether front-loading is a good option. For each beneficiary of a 529 Savings Plan, you can transfer in one year up to five years' worth of the annual gift tax exclusion ($19,000 in 2025), so a total of $95,000 per person (or $190,000 per couple). The maximum investment in each 529 depends on the state, ranging from around $250,000 to $500,000.

What if the young person wants to use the money for something other than education? Here, you have options beyond withdrawing the assets and paying the tax: If the 529 Savings Plan account has been open for at least 15 years, up to $35,000 (lifetime max) can be transferred to a Roth IRA for the beneficiary (if they have earned income), subject to the annual Roth contribution limits. Or you, as the account owner, can switch beneficiaries at any time. You can even name yourself as the beneficiary.

Trusts: Lifetime Support as Part of Family Legacy

Trusts are powerful supports that can apply over a lifetime, from childhood into adulthood. The major benefits of setting up a trust and naming your children as beneficiaries are control, privacy, potential transfer tax savings and asset protection from creditors. You, the grantor, can decide how your children/grandchildren will interact with your wealth over an extended period of time.

Trusts allow you to specify for what, when, how money will transfer to children, allowing consideration of their unique abilities, interests and circumstances. Access to the funds (and the amount) can be staggered – for example, at ages 25, 35 and 45. Interestingly, the name/title of the trust can be quite generic and not include the names of the children it will benefit.

Keep in mind that where a trust is based greatly determines how it functions. Trusts based in South Dakota, for example, can operate forever (aiding with multi-generational wealth transfer) and can be created and operate in "silence," unbeknownst to the beneficiaries or anyone other than the trustee. In some other states, the trustee must notify the beneficiaries of the trusts existence when they turn 18.

Deciding which type of trust structure is best takes careful consideration, and this is something we spend a lot of time on with clients as well as the attorney drafting the trust document. You will need to name a trustee to administer the trust (your children can be co-trustees along with a corporate trustee such as LNW); and annual tax reporting is required. For many families with significant wealth, the great flexibility and control provided by a trust are well worth the effort of planning and funding it.

Parting Thoughts

Each of the above account types can help children stand on their own two feet once they leave the family home and venture out on their own. They can be used as tools to educate, open up conservations around money, and motivate them to use money for the benefit of themselves and others.

Whatever your hopes and aspirations for your younger generation(s), explaining to them why you are setting up accounts in their name is important. Knowing your rationale and also the family history can begin to prepare them to be intellectually and emotionally invested in their education, careers, and the family values you want to pass on. And when combined with other family entities – LLCs, donor advised funds, etc. – families can continue to thrive as the younger and older generations are linked by a shared history and values, as well as financially.

ABOUT THE AUTHOR

Kate Donnelly is a Wealth Manager at LNW. For more than two decades, she has advised people and families with multigenerational wealth, with a special focus on exploring how assets – financial and personal – can be put to their highest use. An educator at heart, Kate excels at listening, explaining complex financial strategies clearly, and being there to answer any and all questions. The discussion might be focused on investments and finances. But more often than not, it will also touch on a major life choice her clients face, or what they can do to really make a difference in the region they call home.

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