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METHODS AND CONSEQUENCES OF GIFTS TO MINORS

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I. Outright Gifts.

A. Easy to transfer property to minor outright.

B. Accomplishes tax goals.

1. Income from property taxed to minor, except for "kiddie tax" situations.

2. Qualifies for annual gift tax exclusion.

3. Not included in donor's estate.

C. Practical consequences are the major drawback.

1. Minor gains control over gift (subject to legal incapacity).

a. Majority reached at age 18, at which time child has full control over gifted property.

b. Possible (inevitable?) eroding of minor's incentive if gifts substantial.

c. Child can withdraw funds in bank if child is able to sign and understand the nature of the act of withdrawal. A.R.S. §§6-235(A), 6-432.

2. Because of minor's incapacity, cannot deal with property effectively during minority (e.g., to sell property).

a. In order to deal with property must have conservator appointed, a costly process. A.R.S. §14-5401 ff.

(1) initial court appointment.

(2) expense of surety bond

(3) filing of inventory and annual accountings.

(4) court approval may be necessary for sales and investments.

II. Custodianships.

A. Custodianships under Uniform Transfers to Minor's Acts are designed to avoid expense and inconvenience of conservatorships. See Peterson, "The Uniform Transfers to Minors Act: a Practitioner's Guide," Army Lawyer 3 (May 1995)

1. UTMA allows any type of property to be transferred to minor with no restriction upon amount or upon donor.

a. Uniform **Gifts** to Minors Act (UGMA) was limited to gifts of money and securities.

b. Arizona operates under the UTMA as do most all states now.

2. Minor can be shareholder in S corp, member in LLC or limited partner in limited partnership under the UTMA.

B. Accomplishes tax goals, if careful.

1. Income from gifted property taxed to minor.

a. However, taxed to parents to the extent income from the gift is used to discharge parents' legal obligation to support the minor **whether or not the parent is serving as custodian**. Rev. Rul. 56-484, 1956-2 CB 23; Rev. Rul. 59-357, 1959-2 CB 212. *See* III.D.3 *infra* for discussion of "support".

b. UTMAs for children under age 14 are subject to "kiddie tax". Section 1(g)[1]—child is taxed at parents' highest marginal federal tax bracket on unearned income in excess of $1600.

2. Not included in donor's estate unless the donor is the custodian at the time of the donor's death.

a. Remember that each spouse is the donor of community property.

b. If donor serves as custodian and dies before the donee reaches majority, then the assets are includible in donor's estate. Estate of Lober, 346 U.S. 335 (1935)

[1] All unidentified Section (§) references are to the Internal Revenue Code of 1986, as amended.

3. Gift under Uniform Act qualifies for annual exclusion.

4. Tax effects the same where a conservatorship is used.

C. Disadvantages of Custodianships.

2. A fund may not be established for more than one donee.

3. Custodial arrangement cannot be extended beyond age 21 (age 18 in some states).

4. Cannot establish "joint" custodians under the Uniform Act.

5. Custodian subject to "prudent person" investment standards in some states. May retain any custodial property received from a transferor. A.R.S. §14-7662B.

6. Difficulty of naming successor custodians. A.R.S. § 14-7668.

7. If minor dies before attaining majority without spouse or child, property passes back to parents, defeating parent's gift program.

8. Custodial property is subject to probate in the minor's estate.

9. UTMA account is subject to child's creditors, i.e. no spendthrift protection.

10. Property will be counted as child's property for financial aid purposes

D. Creating a custodianship is simple.

1. Property is transferred to name of custodian "as custodian for [name of minor] under the Arizona Uniform Transfers to Minors Act".

2. Attend to naming successor custodian.

III. <u>Section 2503(c) Trusts</u>.

A. Current income tax treatment of non-grantor trusts vis-à-vis individuals:

1. Some benefit to use of trust's lower tax rates on accumulated income.

2004 FEDERAL TAX RATE SCHEDULE FOR NON-GRANTOR TRUSTS[2]

Taxable Income	Tax on Left Column	Tax Rate on Excess
-0-	-0-	15%[3]

[2] Unofficial

[3] 10% bracket which applies to individuals does not apply to trusts and estates. Section 1(i)(A).

1950	293	25%
4600	955	28%
7000	1627	33%
9550	2469	35%

a. Exemption of $100 for complex trusts, $300 for simple trusts.
b. 15% rate on dividend income and long term capital gain.
c. 5% rate on long term capital gains otherwise taxed at 15%

2. Accumulation of all income in trust while beneficiary is under age 14 appears advisable if minor has at least $1,600 of other unearned income.

3. If child's other unearned income is less than point at which "kiddie tax" kicks in, income splitting between trust and child by making income distributions to the child offers most benefit.

4. After child is 14 years of age, advantage of accumulating income is significantly reduced.

2004 FEDERAL TAX RATE SCHEDULE FOR UNMARRIED INDIVIDUALS[4]

Taxable Income	Tax on Left Column	Tax Rate on Excess
-0-	-0-	10%
7,150	715	15%
29,050	4000	25%
70,350	14,325	28%
146,750	35,717	33%
319,100	92,593	35%

a. 15% rate on dividend income and long term capital gain
b. 5% rate on long term capital gains otherwise taxed at 10% or 15%
c. The standard deduction amount under § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $800 or the sum of $250 and the individual's earned income.

B. Requirements for Section 2503(c) trusts.

1. Trustee must have discretion to distribute income and principal to the minor before he or she reaches the age of 21.

a. If only income can be so expended, income interest alone qualifies for the annual exclusion.

[4] Unofficial

(1) If donor is hesitant to allow minor to receive principal at age 21, § 2503(c) trust with only qualifying income interest is worth considering.

(2) With this, principal can be held to later date with all accumulated income payable at age 21.

b. Regulations provide there can be "no substantial restrictions" under the trust instrument on the exercise of the trustee's discretion. Treas. Reg. §25.2503-4(b).

(1) In drafting, do **not** require taking minor's other resources into account in making distributions. *See* Rev. Rul. 69-345, 1969-1 C.B. 226 (parents retained effective control by requiring trustee to consider donee's other support). *Contra*, Craig v. Commissioner, 30 T.C.M. (CCH) 1098 (1971) (precluding invasion before all other sources of income distributed not a restriction when applicable state law imposed a like restriction upon guardians); Mueller v. United States, 69-1 USTC ¶12,592 (W.D. Mo. 1969).

(2) Distribution standard of allowing trustee to expend trust funds necessary for "support, care, education, comfort and welfare" approved in Rev. Rul. 67-270, 1967-2 C.B. 349. Accord, Heidrich v. Commissioner, 55 T.C. 746 (1971) ("education, comfort, and support" approved). See also Mueller ("support, health and education" approved); Craig ("care, support, maintenance and education, or in case of emergency" approved).

2. The minor, on becoming 21, must be entitled to outright distribution of the property, including any accumulated income. However, there are alternatives to outright distribution:

a. The minor, but not the donor, trustee or a third party, may be given the power to extend the trust. Treas. Reg. ¶25.2503-4(b)(2).

b. In Rev. Rul. 74-43, 1974-1 C.B. 285, the Service ruled that a trust would satisfy Section 2503(c) as long as the trust provides the beneficiary upon reaching age 21 with either (1) a continuing right to compel immediate distribution of the trust corpus by giving written notice to the trustee, or (2) **a right during a limited period to compel immediate distribution of trust corpus,** by written notice to the trustee. PLR 7824035 (3/5/78) approves a 30-day period.

3. If the minor dies prior to reaching 21, the entire trust property (including any accumulated income) must pass to minor's estate or be subject to a general power of appointment.

    a. In the absence of a general power of appointment, property must specifically pass to "estate." In Ross v. Commissioner, 652 F.2d 1365 (9th Cir. 1981), court disallowed annual exclusion when trust instrument provided for "heirs at law" rather than "estate", because property passing to "heirs at law" would not be subject to estate tax.

    b. Irrelevant whether beneficiary is too young to exercise power of appointment under state law. Treas. Reg. § 25.2503-4(b). However, cannot restrict ability to exercise beyond what local law provides. Gall v. United States, 521 F.2d 878 (5th Cir. 1975), cert. denied, 425 U.S. 972 (1976).

    c. Use of general power of appointment and then providing gift in default of appointment avoids both probate and property passing back to parents by intestacy statute. See PLR 8334071 (5/25/83).

C. Can avoid adverse estate or income tax effects, if careful.

1. Qualifies for annual gift tax exclusion even though trustee is given discretion regarding payment or accumulation of income and principal.

2. .If the donor serves as trustee, trust property may be included in donor's gross estate under I.R.C. §§2036(a) and/or 2038. See Varlan v. Commissioner, 47 T.C. 34 (1966), aff'd, 396 F.2d 753 (9th Cir.), cert. denied, 393 U.S. 962 (1968).

    a. I.R.C. §2036(a)(2)--retained "right . . . to designate the persons who shall possess or enjoy the property or the income therefrom".

    b. I.R.C. §2038--retained "power to alter or amend the terms of the gift".

    c. A power to become a substituted trustee may cause includability. Mathev v. United States, 73-2 ¶USTC 12,936.

3. If a parent having a legal obligation to support beneficiary serves as trustee, trust property may be includable in parent's estate under § 2041 as a general power of appointment. Treas. Reg. §2024-1(c)(1). Some courts have held that use of an ascertainable standard cures the problem. See, e.g., Estate of Cutter v. Commissioner, 62 T.C. 351 (1974). However, then the "no substantial restriction" test might not be satisfied.

a. Obviously, if parent will not have a taxable estate then this result is irrelevant.

b. Query: will a parent's power to remove and replace trustee (even if parent is not grantor or trustee) result in includability? See PLR 8916032 (parent's removal power causes inclusion where trustee had ability to make discretionary distributions, albeit non-ascertainable, to parent's minor children).

c. Bottom line is that parent should not serve as trustee or have power to change trustee if estate tax is a concern.

4. Under I.R.C. §677(b), use of trust income to discharge support obligations of donor results in such income being taxed to donor. See Rev. Rul. 59-357, 1959-2 C.B. 212.

a. What are support obligations? Depends on local law. For example, in Brooke v. United States, 300 F. Supp. 465 (D. Mont. 1969), aff'd, 468 F.2d 1155 (9th Cir. 1972), use of income for private school tuition, musical instruments, music lessons, swimming lessons, public speaking lessons and purchase of automobile, was not within local law obligation of support.

b. Conflicting decisions with respect to college education. Clark, The Law of Domestic Relations in the United States (1987, West Publishing) cites the District of Columbia and Florida as jurisdictions that do not consider a college education a "necessary" that implicates a parental support obligation. California and Texas do not extend support obligations beyond the age of 18. *See* CAL FAM CODE § 3901 (West 1994); Jones v. Jones, 225 Cal. Rptr. 95 (Ct. App. 2d Dist. 1986)(child could not compel father to pay for college education when child was past age of 18); TEXAS FAM. CODE ANN. § 14.05(a) (West 1986); **Ewing v. Hold, 835 S.W.2d 274 (Tex. Ct. App. 1992) (parent's support obligation to minor beyond majority (age 18) extends only to completion of secondary education)**. In Pennsylvania, *married* parents do not have any support obligations past age 18, but *divorced* parents might. *See* Pennsylvania College Expenses Act, 23 PA. CONS. STAT. ANN § 4327 (1993). A similar distinction between the support obligations of married and divorced parents exists in Alabama. *See* B.A. v. Alabama Dep't of Human Resources ex rel. R.A., Ct. Civ. App., No. AV92000784 (1994). Clark cites cases from Colorado, Mississippi, New York, Pennsylvania, Missouri, New Jersey, Illinois, Indiana, Alabama, Georgia, Michigan, Oklahoma, South Carolina, Iowa, and Connecticut as requiring payment for college. Some of these states (*e.g.*, New Jersey) may require that the parent pay for graduate school in addition to undergraduate schooling; while other states (*e.g.*, New York (Romansoff v. Romansoff 562 N.Y.S.2d 523 (N.Y. App. Div. 1990) may require college education support only until the minor reaches the age of 21. *See*, Braun, TC Memo 1984-285 (New Jersey law); Turecki v. Turecki , 221 App Div. 2d 450, 633 NYS2d 560 (1st Dept., 1995); *See also*, Kertz, "How To Get More After-Tax Dollars to Pay for College Expenses or Support Dependent Parents," 11 Taxation for Lawyers 278 (1983).

c. In general, **Arizona does not impose support obligation on parents beyond the age of majority**. A.R.S. § 14-320; A.R.S. § 8-101 (age 18); see Solomon v. Findley, 167 Ariz. 409, 808 P.2d 294 (1991)(agreement for post-majority support for college separately enforceable despite divorce court's lack of jurisdiction).

d. Decision in Upjohn v. United States, 72-2 USTC ¶12,888 (W.D. Mich. 1972), is interesting. A trust which precluded distributions for support or maintenance of the donee for which donors were legally obligated did not have "substantial restrictions". Court held that gifts were more complete because free from use for parental obligations.

D. Disadvantages of Section 2503(c) trust.

1. Expense of preparing trust instrument and annual tax returns.

2. Trustee fees if professional trustee used.

3. Difficulty in locating suitable trustee.

IV. Crummey Trusts: Beneficiary has right to withdraw the contribution for a defined period of time, trust continues until beneficiary's specified age(s).

A. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), allowed present interest annual exclusion where a child, or a guardian on child's behalf (including a parent as natural guardian), was given the power, in the year of gift but not later, to withdraw the lesser of value of the donor's gift for that year or a stated amount. See Rev. Rul. 81-6, 1981-1 C.B. 385.

B. Gift Tax Effects.

1. Donor has made gift qualifying for annual exclusion of the lesser of the donor's addition to the trust or the stated amount (e.g., $11,000).

a. In Rev. Rul. 81-7, 1981-1 C.B. 474 if donor's conduct makes the demand right illusory, such as by not communicating its existence and narrowly restricting the time for its exercise, the annual exclusion will be denied. Ruling involved a legally competent adult beneficiary and effect upon notice for minor beneficiaries is unclear.

b. Annual exclusions for Crummey powerholders who are not otherwise beneficiaries problematic. See Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991).

2. Possible gift tax effect on donee: Under Section 2514(c), lapse of the Crummey power constitutes release of a general power of appointment, which is subject to gift tax to the extent the property subject to the power exceeds the greater of $5,000 or 5% of the trust assets ("5 & 5 Amount").

a. One obvious solution is to limit withdrawal power to 5 & 5 Amount. Allow donor to set amount subject to withdrawal when making addition to trust.

b. Use a one-beneficiary trust. No gift if lapsed property will eventually go to powerholder. PLR 8142061 (7/21/81).

c. Give beneficiary a special testamentary power of appointment to appoint lapsed property. Treas. Reg. § 25.2514-3(c)(1).

d. Use "hanging power" whereby power lapses only to the extent of 5 & 5 Amount in any calendar year. This is commonly used with irrevocable life insurance trusts.

d. If the beneficiary dies during the pendency of the trust, the beneficiary's estate will include property attributable to lapsed powers in excess of 5 & 5 Amount. See Treas. Reg. §20-2041-3(d)(4) for computation.

C. Income tax effects.

1. Under I.R.C. §678(a) lapse of power will cause **powerholder** to be treated as grantor for income tax purposes of the portion that could have been withdrawn. This is the case even if trustee thereafter distributes to other beneficiaries or accumulates the income on such portion. See Rev. Rul. 67-241, 1967-2 C.B. 225.

2. Thus, income taxation of Crummey trust is often complicated for a non-grantor multi-beneficiary trust.

3. **Best to structure the Crummey trust as a grantor trust**. Either make it a single beneficiary trust (and be careful not to allow any provisions which

would allow the donor to be considered as grantor for income tax purposes[5]) or make it an intentionally defective grantor trust.

a. Beneficiary grantor trust—takes advantage of beneficiary's lower income tax brackets, especially with respect to long term capital gains tax.

b. Donor (intentionally defective) grantor trust

1. Takes advantage of donor's payment of tax on income given to child so as to maximize value of gift to child, [these tax payments are not subject to gift tax], thus, child can realize a "tax-free" return from taxable income securities.

2. Simplifies preparation of income tax returns because parents are taxed on trust income--not child.

3. No child's return is required if child has no other income (or below filing amount).

c. Consider using a "toggle" provision to switch from donor grantor trust to beneficiary donor trust when child reaches age 14.

V. <u>Clifford Trusts for Children Under 14</u>.

A. Example: Parents create a $33,871 trust for 2-year-old child which provides for all income to be paid to or for the benefit of the child until the close of the tax year in which child attains age 13, at which time trust reverts to parents.

B. Present Value of Income Interest to Child: $22,000 (.649506 x $33,871)-- no adverse gift tax effect.

C. Value of parents' reversionary interest exceeds five percent; thus, parents are taxed on all income under Section 673(a).

D. Advantages.

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[5] Use language like this: "Nothing contained in this agreement shall be construed as authorizing anyone to purchase, exchange or otherwise deal with or dispose of the principal or income of the trust for less than an adequate consideration in money or money's worth (except for distributions to the beneficiary); or as authorizing a grantor to borrow the principal or the income of the trust directly or indirectly; or as authorizing any trustee to exercise any power other than in a fiduciary capacity. The trustee shall not use any portion of the trust to discharge any legal obligation (including any legal obligation to support dependents) of a grantor or any person who has the power to remove a trustee. The trustee shall not pay any premiums on insurance on the life of a grantor or any person who has the power to remove the trustee."

1. Simplifies preparation of income tax returns because parents <u>are taxed on trust income</u>--not child.

2. No child's return is required if child has no other income (or below filing amount).

3. Parents' payment of tax on income given to child maximizes value of gift to child, [these tax payments are not subject to gift tax], <u>i.e.</u>, child can realize a "tax-free" return from taxable income securities.

4. Accumulate income in trust--upon termination child receives accumulated income.

VI. <u>Section 529 Plans</u>.

A. Two types of Section 529 Plans (sometimes referred to as qualified tuition plans or "QTPs")

1. Pre-paid tuition plans (PTPs). Section 529(b)(1)(A)(i).

2. Educational savings accounts (ESAs). Section 529(b)(1)(A)(ii).

B. Primary advantage is that QTP is exempt from federal income tax as long as distributions are made for qualified higher education expenses of the "designated beneficiary".

1. If distribution is made to designated beneficiary but not so used, then income portion is taxed as ordinary income at beneficiary's bracket plus 10% penalty tax. If account owner takes distribution, then tax is at account owner's bracket plus 10% penalty tax.

2. We expect that Arizona will follow federal rules.

3. Often overlooked disadvantage is that there is no benefit to losses; also lose benefit of favorable long-term capital gains and dividend rates.

C. Any "person" can make cash contributions to a QTP. Section 529(b)(1)(A). The account owner controls investments and the designated beneficiary.

1. Prop. Treas. Reg. § 1.529-1(d) provides that "person" has the same meaning as under Section 7701(a)(1).

2. Section 7701(a)(1) defines "person" to include "an individual, a trust estate, partnership, association, company or corporation." The regulations provide that the term also includes a guardian, executor, administrator, conservator or any person acting in a fiduciary capacity. Treas. Reg. § 301.7701-6(a).

3. Can UTMA custodian liquidate assets and contribute property to QTP? It appears custodian would be violating fiduciary duty to minor unless assets are deliverable to minor at age of majority (without adverse income tax consequence?).

4. Trustee should be an allowable account owner but an individual must be the beneficiary. This does avoid the problem of providing for a successor account owner.

5. Account owner can change the beneficiary among account owner's parents, children, step-children, cousins and various spouses. Section 529(e)(1).

D. Gift and Estate Tax Effects.

1. Typically plans allow contributions of over $250,000 for an ESA. *See*, www.smartmoney.com, www.savingforcollege.com.

2. Section 529(c)(2)(B) allows a contributor to "front-load" the contributions for five times the annual exclusion, thus $55,000 ($110,000 with gift-splitting), every five years.

3. There is a recapture of excess annual exclusion if contributor dies within the five year term.

4. Otherwise, there is no inclusion for estate tax purposes, Section 529(c)(4)(A), except for a cryptic reference to "amounts distributed on account of the death of a beneficiary". Section 529(c)(4)(B).

5. ESA Investments prescribed by program sponsor—leads to **loss of investment flexibility and difficulty in ascertaining fees and costs assessed**.

VII. Other Planning Mechanisms.

A. Section 2503(e) exclusion for **tuition** payments paid directly to an educational institution.

B. Coverdell Educational Savings Accounts (CESAs)

1. Provided for under Section 530.

2. Maximum amount of contribution of $2000/year/beneficiary

3. Subject to phase-out (MAGI of $95,000-$110,000 for single taxpayer, $190,000-$220,000 for joint filers).

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