Morgan Stanley

Giving to Minors

Estate Planning

Overview

Wealth and Estate Planning Strategists
Family Office Resources

A significant part of estate planning involves transferring assets to future generations. Rather than wait until death, estate planning transfers in the form of lifetime gifts can allow for more efficient tax planning. Giving an asset during the donor's life removes all future income and appreciation of such asset from the donor's taxable estate.[1] In addition, a gift of income producing assets to an individual in a lower income tax bracket can lower the overall income tax burden with respect to that asset.

Since many gifts to future generations involve gifts to minor children, special planning must be employed to ensure that the gift meets the donor's tax and non-tax objectives. From a gift tax perspective, a gift to a child or grandchild often is intended to qualify for the annual exclusion. Under current law, an individual may give up to $10,000 (indexed for inflation, $16,000 in 2022)[2] to as many people as he or she likes, without incurring federal gift tax and without using any of the donor's lifetime federal gift tax exemption.[3]

[1] In some circumstances, the donor must survive for a certain number of years after making the gift before the gifted asset is completely removed from the donor's federal taxable estate.

[2] Married couples can elect to "split" a gift, which effectively doubles the amount that the married couple may give to each person without incurring federal gift tax, even if only one spouse is the source of the funds. In 2022, that amount is $32,000, per married couple. However, in order to split a gift, the gift must be reported on a federal gift tax return signed by both spouses.

[3] Under current law, in addition to the annual federal gift tax exclusion amount per donee, each US person has a lifetime federal gift tax exemption, now $10 million, indexed for inflation ($12.06 million in 2022).

Outright Gift

The simplest method of transferring assets is by outright gift. An outright gift qualifies for the annual gift tax exclusion.

Advantages:

- Simplicity—an outright gift does not require the establishment of a distinct legal entity or custodianship.

Disadvantages:

- A minor may be unable to deal with the property practically and/or legally.

- The recipient of the gift will take the donor's basis in the property for income tax purposes.

Medical and Education Expenses

Unlimited payments can be made directly to: (1) an educational institution for tuition and (2) a health care provider for medical expenses (including health insurance premiums), on behalf of any individual, without federal gift or generation-skipping transfer tax consequences.

Transfers in Trust

A more versatile method for transferring assets to a minor is in trust. A trust can prevent a minor from exercising control over the trust assets at a young age and allows the transferor to choose the Trustee who will manage the assets. It also permits the transferor to determine precisely when and how the trust income and principal will be distributed to the minor. However, a transfer in trust generally is a transfer of a "future interest," which does not qualify for the annual exclusion from federal gift tax unless the trust contains specific provisions to create a "present interest" for the minor beneficiary.

Minors’ Trusts

A transfer in trust for a particular beneficiary will qualify for the federal gift tax annual exclusion if: (1) the beneficiary is less than 21 years old at the time of the gift; (2) the property and income of the trust may be expended by or for the beneficiary prior to attaining the age of 21; and (3) any property and income remaining in trust passes to the beneficiary upon attaining the age of 21 (or is included in his or her gross estate if he or she dies before age 21). Many practitioners satisfy this requirement by giving the beneficiary a right to withdraw the trust property at age 21. If the withdrawal right is not exercised within a certain time period, it will lapse and the assets will remain in trust.

Advantages:

- Relative simplicity.
- Beneficiary has no access to the funds other than a withdrawal right upon attaining age 21.

Disadvantages:

- The trust must permit the minor to demand distribution of the trust assets upon attaining age 21.
- A minor’s trust may have only one minor beneficiary so a separate trust must be established for each minor child.
- The trust will take the donor’s basis in the property for income tax purposes.

UGMA and UTMA Accounts

Like a minor’s trust, a gift to a custodian under the Uniform Gifts to Minors Act (UGMA) or the newer Uniform Transfers to Minors Act (UTMA) creates a fiduciary relationship similar to a trust for the benefit of the minor. Under either statute, a custodian holds the property for the sole benefit of the minor. The custodian has the obligation to turn over the assets in the custodial account to the minor upon the minor attaining the custodial Age of Termination, in general, age 18 under the UGMA or age 21 under the UTMA. A transfer to an UGMA or UTMA custodianship qualifies for the federal gift tax annual exclusion.

Advantages:

- A transfer under the UGMA or UTMA establishes a trust-like relationship but does not require the creation of a trust.

Disadvantages:

- If the donor names himself or herself as custodian and dies before the property is distributed outright to the minor, the property will be included in the donor’s estate for estate tax purposes.
- Any person who has a legal obligation to support the minor, regardless of whether such person serves as custodian, must recognize income to the extent distributions from the custodial property are made for the support of the minor.
- Terms of the custodianship are dictated by state law and may not be varied.
- As to any non-cash transfers to the account, the custodian (and, upon termination of the account, the minor) takes the donor’s basis in the property for income tax purposes.

Withdrawal Rights (Crummey Trusts)

As mentioned earlier, gifts in trust generally do not qualify for the annual exclusion from the federal gift tax. Therefore, irrevocable trust agreements frequently contain provisions that allow the trust beneficiaries to exercise withdrawal rights over contributions to the trust (generally the right to withdraw up to the annual exclusion amount). The right to withdraw transforms the gift in trust into a gift of a present interest, thereby qualifying the gift for the annual exclusion. These withdrawal rights, which are frequently contained in insurance trusts, are commonly called “Crummey” withdrawal rights after *Crummey v. Commissioner*, the seminal case that approved this technique. Although no explicit or tacit agreement may be entered into, the expectation is that the beneficiaries will allow their withdrawal rights to lapse so that the transferred assets may be held in trust to be accumulated or distributed in accordance with the donor’s wishes. Note that multiple beneficiaries of one trust may be given Crummey withdrawal rights over a portion of each gift to the trust so that a large gift may qualify as separate annual exclusion gifts to the many beneficiaries. If the beneficiaries allow the withdrawal rights to lapse, the assets then belong to the trust and may be accumulated and/or distributed to any of the trust beneficiaries, not necessarily the beneficiary who had the withdrawal right over such property at the time of the gift.

Advantages:

- A Crummey Trust may extend to any age.
- A Crummey Trust may have more than one beneficiary.

Disadvantages:

- The formalities of providing notice of the right of withdrawal to the beneficiaries (referred to as “Crummey notices”) upon the contribution of assets to the trust must be followed and must be documented. The IRS is hostile to abuses of Crummey powers and often requests proof that notice was provided to the beneficiaries upon audit.
- The beneficiary may actually exercise the Crummey power and withdraw the gifted property.
- Complex drafting is required so that the failure of a beneficiary to exercise a right of withdrawal does not cause a taxable gift from that beneficiary to the other trust beneficiaries.
- Automatic rights of withdrawal for members of a particular class, e.g., children, may provide rights to beneficiaries who subsequently fall out of favor with the donor.
- The trust will take the donor’s basis in the property for income tax purposes.

529 Accounts

529 Accounts are tax-advantaged savings accounts for post-secondary education expenses, including for college, university or vocational school. In addition, up to $10,000 may be withdrawn annually for certain pre-college educational expenses of a beneficiary and up to a lifetime limit of $10,000 per individual can be withdrawn and paid as principal or interest on any qualified education loan of either the beneficiary or a sibling of the beneficiary. While post-tax cash is gifted to the 529 account, the investment income is not taxable and withdrawals are tax-free so long as the withdrawals are utilized for qualified education expenses.

Kiddie Tax

Unearned income of a child in excess of a certain amount ($2,300 as of 2022) will be taxed at the parents' tax rates. This "kiddie tax" generally only applies to (1) a child who is under age 18 at the end of the tax year or (2) a child that was age 18 at the end of the year or a full-time student at least age 19 and under age 24 for a child whose earned income does not exceed half of the annual expenses for his or her support. A child who turns 19 (or 24) by the end of the tax year is not subject to the kiddie tax. Parents may elect to include a child's unearned income on their own income tax return, in certain circumstances.

The kiddie tax applies only to unearned income a child receives from income-producing property (or investment property), such as interest and dividend income from cash, stocks, bonds, mutual funds, and real estate. Any salary or wages that a child earns through full-or part-time employment are not subject to the kiddie tax rules – that income is taxed at the child's regular income tax rate.

Summary

Following is a summary of the different considerations in making gifts to a child.

	HOW IT WORKS	INCOME TAXATION	ADVANTAGES	DISADVANTAGES	MAY BE BETTER WHERE
Outright Gift	• Transfer title to minor	• Beneficiary taxed on income; if minor under 19 (or 24 and a full-time student) kiddie tax applies	• Simple	• Property ownership by minor may not be allowed under state law • Child has control • Carryover basis	• Child responsible; • Small gifts planned; • Qualifying for annual exclusion gift desired
UGMA/UTMA	• Transfer property to custodial account; property held for benefit of minor until age 18/21 when distributed	• Beneficiary taxed on income; if minor under 19 (or 24 and a full-time student) kiddie tax applies (except where parent/guardian taxed on support distributions)	• Simple; no trust required • Beneficiary may not withdraw property until 18/21 • Assets available for beneficiary's benefit	• Minor gets property at 18/21 • Estate tax inclusion if donor-custodian dies before distribution • Income taxed to parent where property distributed to support minor-child • Terms fixed by state law • Carryover basis	• Small gifts planned • Simplicity desired • Qualifying for annual exclusion gift desired
Minor's Trust	• Property held in trust for benefit of minor until age 21 (or earlier death) when distributed	• In general, minor taxed on income distributed, unless structured as a grantor trust.	• Relatively simple • Beneficiary may not withdraw property before 21	• Trust can have only 1 beneficiary • Minor must have right to property at 21 (unless minor extends trust) • Carryover basis	• Qualifying for annual exclusion gift desired • Simplicity desired
Crummey Trust	• Property held in trust to any age; beneficiary given power to withdraw additions to trust	• Beneficiary may be taxed on income distributed and income attributed to property subject to withdrawal right, unless structured as a grantor trust	• Trust can extend to any age • Trust can have multiple beneficiaries	• IRS scrutiny • Beneficiary may withdraw property • Lapse of withdrawal right may cause gift tax problems, without careful drafting • Carryover basis • Withdrawal notices increase administrative burden	• Need to qualify for annual exclusion gifts for multiple beneficiaries • Larger gifts planned

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Important Disclosure

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