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Annual Exclusion Gifts to Minors

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Since the unification of the federal estate, gift and generation-skipping transfer tax exemption amounts in 2011 to $5 million and the signing of the American Taxpayer Relief Act of 2012, making the exemption amounts (adjusted for inflation) permanent, the historically large lifetime gift tax exemption has been the focus of estate planning. However, another significant component to a robust wealth transfer program is annual gifts that are eligible for the gift tax exclusion. In 2013, the annual gift tax exclusion amount increased from $13,000 to $14,000 (or $28,000 if spouses elect to split gifts). With this increase, parents and grandparents can make annual gifts to their children and grandchildren that easily exceed $100,000 per year without paying a gift tax or reducing the lifetime gift tax exemption amount.[1] Over time, annual gifting can effectively reduce the donor's gross estate by not only removing the value of the gifts but all the future appreciation associated with those gifts.

When making annual gifts, the donor must decide what gifting method to utilize. The least complicated method is an outright gift. However, when dealing with a minor, an outright gift of any substantial size is almost always inappropriate. Thus, the donor must evaluate alternative methods that include some level of continued control to preserve the gift and let it grow for the benefit of the minor. This article discusses commonly utilized methods for making annual exclusion gifts to minors and when a particular gifting method is most appropriate.

New York UTMA Account

Transferring property to a custodian pursuant to New York's Uniform Transfers to Minors Act (UTMA) is one of the easiest and least expensive methods for gifting to a minor.[2] Enacted to replace the more rigid Uniform Gifts to Minors Act (UGMA) for transfers of custodial property after Jan. 1, 1997, UTMA accounts provide a means to reduce one's gross estate for the benefit of a minor child or grandchild without the need for appointing a guardian or creating a trust. The Internal Revenue Service (IRS) ruled that these gifts under local statute meet the requirements of Section 2503(c) of the Internal Revenue Code and, thus, qualify for the annual gift tax exclusion.[3] While this is a convenient and inexpensive method for gifting to a minor, the considerations discussed below make clear that UTMA accounts should be utilized for smaller gifts and avoided for more significant wealth transfer programs.

There are a number of factors to consider before opening a New York UTMA account. The most significant factor is that the beneficiary receives the gifted property outright upon termination of the custodianship, which is when the beneficiary turns 21 years of age, unless the age 18 option is elected pursuant to New York's Estates, Powers and Trusts Law (EPTL) §7-6.21. The required distribution is often overlooked because the donor may not appreciate how quickly the value of the property can grow or that a 21-year-old beneficiary may not be mature enough to manage the funds responsibly. The issue becomes compounded when parents try to circumvent the eventual distribution by transferring the assets out of the custodial account or merely failing to turn over the property. Such conduct is in violation of the custodian's fiduciary duties and can lead to liability even if the parent continues to utilize the funds for the benefit of the beneficiary.

Another factor to consider is the selection of the custodian. If a goal of the UTMA account is to reduce the donor's gross estate, the donor should not be the custodian or successor custodian. The IRS ruled that custodial property is includible in the donor's estate when the donor is the custodian and dies while serving in that capacity.[4] Parents can avoid this by having one parent be the donor and the other be the custodian.[5] However, when a parent is the custodian, income tax issues arise if the funds are utilized for the minor's support. While this is easily avoidable, parents who spend down a UTMA account to reduce the likelihood of a large distribution at termination can become exposed to this tax trap.[6]

A final consideration is the confusion between a UTMA and Totten Trust[7] account. When opening an account for a minor at a financial institution, a parent or grandparent will usually be presented with both account types, but will not understand the differences or, in the case of an annual gifting program, that a Totten Trust account is not an appropriate alternative. For this reason, it is important to briefly discuss the characteristics of a Totten Trust account.

A Totten Trust account is referred to as an "in trust for" account or a "poor man's will" because it serves as a mere testamentary substitute. Unlike a UTMA account, contributions to a Totten Trust are revocable until the depositor's death. This results in the contributions being considered incomplete transfers for gifting purposes and causes the contributions to be includible in the depositor's gross estate. Also, if the depositor dies while the beneficiary is a minor, the funds become the property of the minor often necessitating the appointment of a guardian of the minor's property. Accordingly, a Totten Trust is quite different from a UTMA account and should be avoided when evaluating alternatives for any annual gifting program to a minor.

Section 2503(c) Trust

To avoid the limitations of a UTMA account, the donor may be better served to make annual exclusion gifts to a minor through a Section 2503(c) trust for the minor's benefit. Gifts made to a properly drafted Section 2503(c) trust are considered "present interest" gifts, which qualify for the annual gift tax exclusion. The trust does not have to terminate like a UTMA account when the beneficiary reaches 21 years of age.

To attain the "present interest" qualification, the trust must be for the beneficiary's benefit and the beneficiary must have the power to withdraw the trust property upon reaching 21 years of age. The withdrawal power need only exist for a limited period of time (e.g. 60 days) and the beneficiary may elect not to withdraw at age 21. If the beneficiary fails to exercise the withdrawal power, the property continues in trust and the trust can provide appropriate distribution and payout terms until the beneficiary reaches a more mature age. This is a common result because the beneficiary will not want to displease the donor who can always reduce or eliminate the beneficiary's ultimate share from the donor's remaining estate assets.

While there is always a risk of the property being withdrawn, a Section 2503(c) trust is preferable over a UTMA account because the trust provides better control over the property and the seamless management of the property once the beneficiary turns 21.[8] A Section 2503(c) trust can also provide for alternate beneficiaries according to the donor's intentions if the beneficiary dies prior to attaining 21 years of age and fails to provide for such contingency. Finally, a Section 2503(c) trust can provide options for shifting the income tax burden for more sophisticated income tax planning.

Crummey Trust

If the withdrawal power in a Section 2503(c) trust makes the donor uncomfortable and the benefits of a trust are desirable, then a Crummey trust[9] is an alternative to avoid a windfall when the minor beneficiary turns 21 years of age. Similar to a Section 2503(c) trust, gifts to a Crummey Trust are "present interests" that qualify for the annual gift exclusion through a withdrawal power in the trust agreement. The key difference is that the power to withdraw in a Crummey Trust occurs on an annual basis, and the amount subject to the power is limited to the annual exclusion amount for that year.[10] Unlike a Section 2503(c) trust, the power does not extend to the entire trust property at a future point in time, which could consist of all prior gifts and substantial appreciation.

A Crummey Trust is more flexible than the UTMA account or Section 2503(c) trust because it can be for the benefit of one or more minor and/or adult beneficiaries. Distribution standards and investment options can be tailored depending on the unique circumstances of the beneficiary and the type of property transferred to the trust. The trust may terminate when the beneficiary attains a specific age or continue for the beneficiary's lifetime and beyond. With proper drafting, gifts made to the trust escape inclusion in the gross estate of both the donor and beneficiary.

Another significant consideration is that the donor maintains a level of effective control over the gifting program. First, if the beneficiary exercises the withdrawal power or the circumstances of the beneficiary changes, the donor may stop or reduce gifts to the trust at any time. Second, the trustee chosen by the donor can terminate the beneficiary's power of withdrawal over future annual gifts. Taken together, the beneficiary will think twice before exercising the withdrawal power and the gifts ultimately stay in trust until the trustee makes distributions.

The major disadvantage of a Crummey Trust is the notice requirement that is followed for gifts to qualify for the annual exclusion.[11] This includes providing the beneficiary with notice that a gift was made and that the beneficiary has the power to withdraw. To ensure compliance with this requirement, practitioners favor written notice that is countersigned and dated by the beneficiary and held by the trustee for safekeeping. When dealing with a minor beneficiary, a parent or guardian can act on behalf of the minor to comply with the notice requirement and exercise the power to withdraw if desired.

The high level of flexibility and control that the donor maintains in utilizing a Crummey Trust clearly outweighs the trust's administrative notice requirement. When the main objective is to accumulate wealth for a minor beneficiary through annual gifts, the donor should strongly consider a Crummey Trust as the gifting method of choice.

529 Plans

A 529 plan is an inexpensive alternative for the donor to provide for a minor's future higher education expenses (e.g., tuition, fees, books, supplies, equipment and certain room-and-board expenses) with gifts that qualify for the annual gift tax exclusion. A 529 plan is less complicated than a trust and may be more practical when the purpose of the donor's gifting strategy is limited to paying for a minor's education expenses.

When creating a 529 plan in New York, there are a number of unique tax incentives that the donor should consider. First, annual gifts may be "frontloaded" so the donor can make the equivalent of five years worth of annual gifts at one time without gift tax consequences. Today, this amounts to a gift of $70,000 or $140,000 if spouses elect gift splitting. Regarding federal income taxes, the funds gifted grow tax-free and qualified withdrawals under the plan are exempt from taxes. Additionally, a New York taxpayer and account owner is entitled to a state income tax deduction of up to $5,000 ($10,000 for married couples filing jointly) on contributions to New York 529 plans.

With its growing popularity, significant assets can accumulate in a 529 plan. This raises the question of what to do with the funds if the minor beneficiary does not participate in a higher education program or does not withdraw all the funds from the plan. In such cases, the plan beneficiary can be changed to an eligible family member of the original beneficiary (brother, sister, first cousin, spouse, etc.) without a penalty or tax consequence. If no such family member is available, the remaining funds will be reduced by taxes and penalties as if a non-qualified withdrawal occurred. Given its simplicity, flexibility and tax benefits, a 529 plan should be considered in conjunction with the gifting methods previously discussed.

Conclusion

Depending on the donor's objectives and the size of the wealth transfer program intended for a minor, there are a number of alternative gifting methods available that are eligible for the annual gift tax exclusion. These methods vary in complexity and expense and provide a broad range of options. The donor must carefully weigh the pros and cons of each alternative to avoid unintended consequences and select the most appropriate gifting method(s).

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Endnotes:

1. Currently $5,250,000 per person due to annual inflation adjustments.

2. Governed by EPTL §§7-6.1 to 7-6.26.

3. Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 56-86, 1956-1 C.B. 449.

4. Rev. Rul. 59-357, 1959-2 C.B. 212.

5. This is true even if the custodian parent consents to gift-splitting. Rev. Rul. 74-556, 1974-2 C.B. 300.

6. In New York, EPTL §7-6.14(c) seeks to protect parent/custodians by prohibiting transfers that relieve a parent's support obligations.

7. The Totten Trust comes from *Matter of Totten*, 179 N.Y. 112, 71 N.E. 748 (1904) and is now governed by EPTL §§7-5.1 to 7-5.8.

8. There is also a Section 2503(b) trust which qualifies the income interest for the annual gift tax exclusion. To obtain the gift tax benefit, the trust must require that all the income be distributed to the beneficiary. This trust is less common today and is not discussed further in this article.

9. Conceived from the facts set forth in *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). For more information on Crummey powers see C. Raymond Radigan and David R. Schoenhaar, "Crummey Powers: A Refresher," NYLJ, Nov. 2, 2009.

10. To avoid potential gift tax consequences from a power of withdrawal that is not exercised, Crummey trusts often provide "hanging powers" that extend a power to withdraw to future years so that the lapse of the power in any particular year does not exceed $5,000 or 5 percent of the value of the trust.

11. While the IRS lost in *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209 (Aug. 30, 2011), a case where Crummey notices were not sent to the beneficiaries, it would be unwise to rely on this decision as the IRS continues to go after trusts when no notice is given.