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GIFTS TO MINORS

Grandparents and other relatives and friends often desire to make lifetime gifts to or for the benefit of a minor child. In making such gifts, the relative or friend may utilize the federal gift tax annual exclusion to transfer money or property to the minor child without incurring gift tax or reducing the donor's gift tax exemption. Currently, the federal gift tax exemption shelters lifetime taxable transfers aggregating up to $5,000,000 per taxpayer, and the federal estate tax exemption shelters transfers at death and lifetime transfers aggregating up to $5,000,000 per taxpayer. In addition, every individual is currently permitted to exempt up to $5,000,000 of property from the application of the generation-skipping transfer tax (called the "GST tax" and generally imposed on transfers to anyone two or more generations removed from the donor, such as to a grandchild or a great niece or nephew).

The federal gift tax annual exclusion allows a donor to make an $13,000 gift to any individual ("donee"), in any calendar year, free of gift and GST tax. A married couple may make a gift of $26,000 to any individual, in any calendar year, free of gift and GST tax. If one spouse makes a gift of $26,000 to a single beneficiary in one year of which $13,000 is to be deemed a gift made by the other spouse, a gift tax return must be filed by April 15 of the year following the year in which the gift is made in order for the entire gift to qualify for the annual exclusion. For the federal gift tax annual exclusion to apply, the gift must be of a present interest; for example, an outright transfer directly to the donee. The annual exclusion is not available if the gift is of a future interest, such as a gift in trust. Gifts to certain trusts, however, will qualify for the gift tax annual exclusion, as discussed below.

Income generated by a gift to a minor is considered unearned income of the minor that is subject to the "kiddie tax" if the minor is under age 14. Under the kiddie tax rule, all but the first $1,500 of unearned income (income from investments) of a child under age 14 is taxed to the child at the greater of the child's tax rate or the parents' tax rate.

Because most donors do not want to make substantial outright gifts to minor children, there are certain techniques that can be used to avoid this problem. The following discusses the advantages and disadvantages of some of these techniques, including: (1) gifts to a custodian for a minor under Uniform Transfers to Minors Acts; (2) Section 2503(c) trusts; (3) Crummey trusts; (4) Section 529 Qualified Tuition Programs; and (5) Education IRAs.

Gifts to a Custodian Under Uniform Transfers to Minors Acts

Gifts to a minor in a custodial account created under a Uniform Transfers to Minors Act qualify for the federal gift tax annual exclusion. All states and the District of Columbia have some such act. The custodian of such an account has the power to distribute any property in the account to or for the benefit of the minor child. The custodian could be the donor, the minor's parents, another adult, a bank or a trust company.

If the donor acts as custodian, however, the property will be included in the donor's gross estate for federal estate tax purposes if the donor dies before termination of the custodianship. Additionally, because a parent has a legal obligation to support a minor child, if a parent custodian dies before termination of the custodianship, the Internal Revenue Service may argue that the parent's gross estate includes the custodial assets. The income of the custodial property is taxed to the minor, subject to the kiddie tax rules discussed above.

One drawback to transferring gifts to a minor in a custodial account is that the minor obtains complete control of the gift at the age specified in the applicable state law (generally age 21, but age 18 in some states, and the donor may specify age 25 in California). Additionally, the availability of funds in the account could decrease the minor's eligibility for financial aid for college. Financial aid formulas typically require a student to contribute 35% of his or her total assets to college costs each year. Parents are expected to pay only 5 to 6%, on average, of their total assets per year. Therefore, significant assets in the child's name could result in the child's not qualifying for as much financial aid as he or she would qualify if the assets were in the names of the parents, or in some other vehicle, such as a trust.

Compared to a trust, custodial accounts are relatively simple and inexpensive to create and administer. Custodial accounts are less flexible than a trust, however, because its terms, including termination when the minor reaches the stated age, are dictated by state law.

Section 2503(c) Trusts

Another device, a Section 2503(c) trust (named after the relevant Internal Revenue Code section), or minor's exclusion trust, allows a donor to make gifts to a minor in trust and still receive the benefit of the federal gift tax annual exclusion and exemption from GST tax. There are three requirements for such a trust. First, the trust instrument must permit the trustee to expend trust assets for the benefit of the minor without placing substantial restrictions on the exercise of the trustee's discretion in making such distributions. Second, if the minor dies before age 21, the trustee must pay the assets to the minor's estate or according to a general power of appointment exercised by the minor. The exercise of a general power of appointment by the minor means that the trust property will be distributed to any person or persons, at such times and in such manner, as the minor directs. Third, the principal and income of the trust must pass to the donee at age 21, or, at the very least, the donee must have the right to withdraw all of the trust property at age 21. The donee's withdrawal right can be a temporary right, but the donee must have this right of withdrawal for at least 30 to 60 days. The trust can provide that any assets not withdrawn will remain in trust until a future date (e.g., when the beneficiary reaches age 30).

As with the custodian of a custodial account, if the donor or a parent serves as sole trustee of the trust, the trust property could be included in the donor's or the parent's gross estate for federal estate tax purposes if the donor or parent trustee dies before the donee reaches age 21. In order to avoid the inclusion of the assets in the parent's gross estate, the parent may serve as a co-trustee, with the trust instrument giving the non-parent co-trustee the power to make any distributions that might satisfy the parent's legal obligation to support the child.

Prior to the beneficiary's turning age 21, income retained by the trust is taxed to the trust. Because the trust is a separate taxpayer, separate income tax returns for the trust must be filed each year. Any income distributed to the beneficiary will be taxed to the beneficiary, subject to the kiddie tax rules discussed above. After the beneficiary turns 21, the beneficiary will be treated as the owner of the trust and will be taxed on all trust income, whether it is distributed or accumulated.

Again, the beneficiary has the right to be in control of all the Section 2503(c) trust property at the age of 21. An advantage that a Section 2503(c) trust has over a custodial account is that the trust may be set up so that the beneficiary must take affirmative action in order to terminate the trust within a certain time period. Thus, if the trust property is substantial, the donor or other members of the beneficiary's family may be able to persuade the beneficiary to not exercise the power to terminate the trust.

Crummey Trusts

If the donor does not want the donee to have the opportunity to terminate a trust for the donee's benefit at age 21, a Crummey trust allows the donor to delay outright distribution. In order for gifts to this type of trust to qualify for the federal gift tax annual exclusion, even the beneficiary or the beneficiary's guardian must have a temporary right to withdraw any contribution made to the trust. This temporary right of withdrawal allows the gift to the trust to qualify for the federal gift tax annual exclusion as a gift of a present interest and is known as a "Crummey power" (the name originates from the court case allowing such withdrawal rights). Each time a donor, whether the original donor or another donor, makes a gift to the trust (including the original transfer to the trust), the beneficiary has a period of time, generally at least 30 days, during which the beneficiary may withdraw assets of the trust having a value equal to some or all of the gift. If the beneficiary does not withdraw such value within the allotted time, the Crummey power lapses, and the gift remains in the trust. A lapse may have estate and gift tax consequences for the beneficiary.

One advantage to using a Crummey trust over a Section 2503(c) trust is that a Crummey trust allows greater flexibility in its terms. For example, instead of requiring the trustee to make distributions without placing any substantial restrictions on the trustee's exercise of discretion, a donor who establishes a Crummey trust may provide in the trust instrument that any distributions are to be only for the beneficiary's education or any other limited purpose. Additionally, a Crummey trust can continue for essentially as long as the donor wishes, as opposed to a Section 2503(c) trust, which must allow the beneficiary to terminate the trust at age 21. Finally, unlike a Section 2503(c) trust, the Crummey right of withdrawal only covers a specific gift for a limited period of time and not the entire trust property at age 21.

Crummey trusts do have the disadvantage of being slightly more difficult to administer, however, than a Section 2503(c) trust. Every time a donor makes a gift to the trust, the trustee must send notices of withdrawal rights to each holder of the Crummey powers, or to the guardian or parent of a minor beneficiary (unless the trustee is the minor's guardian or parent). Another disadvantage is that, for some period after the donor makes a gift, the beneficiary or the beneficiary's parent or guardian has the power to withdraw trust assets. If the donor is uncomfortable giving the beneficiary or the beneficiary's guardian the right to withdraw gifts to the trust, then the donor should not use a Crummey trust. In practice, however, beneficiaries do not often exercise their Crummey powers.

Another issue to consider in connection with Crummey trusts is that transfers to a trust for which distributions can be made to grandchildren will not be exempt from GST tax unless certain requirements are met. In order for transfers to a Crummey trust to be exempt from GST tax, the trust must be for a single beneficiary, and the trust property must be included in the gross estate of the beneficiary for federal estate tax purposes (i.e., the beneficiary must have a general power of appointment, or the trust property must be distributed to the beneficiary's estate at the death of the beneficiary).

In general, income retained by the trust is taxed to the trust. Because the trust is a separate taxpayer, separate income tax returns for the trust must be filed each year. Any income distributed to the beneficiary will be taxed to the beneficiary, subject to the kiddie tax rules discussed above.

Section 529 Qualified Tuition Programs

Most states have adopted or are in the process of adopting a Section 529 Qualified Tuition Program under which a relative or friend may make a cash gift (contributions must be in cash) to a federally tax-deferred account held for a beneficiary's college education expenses. Under a Section 529 plan, funds may be used to pay the beneficiary's "qualified higher education expenses" at an "eligible educational institution." "Qualified higher education expenses" include tuition, fees, room and board and the cost of books, supplies and equipment required for the enrollment and attendance of a beneficiary at an "eligible educational institution." An "eligible educational institution" is an accredited, post-secondary educational institution offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree or another recognized post-secondary credential. As indicated by the term "higher education," costs of attending high school, junior high school, elementary school and pre-school are not covered by qualified tuition programs.

Contributions beyond those reasonably necessary to provide for the beneficiary's qualified higher education expenses are prohibited. Contribution limits are generally between $100,000 and $220,000, and limits vary from state to state.

There are two types of Section 529 Qualified Tuition Programs: (1) pre-paid tuition programs; and (2) education savings account programs. Under a pre-paid tuition program, an individual purchases tuition credits or certificates on behalf of a beneficiary to prepay tuition and fees while locking in current tuition rates. These plans are designed to hedge the increasing cost of higher education. Under an education savings account program, an individual contributes to a state's savings account, established to pay for the designated account beneficiary's qualified higher education expenses. Education savings account programs are usually managed by professional investment companies and have various investment options. The primary option is a managed allocation, age-based approach, where assets are shifted from equities to more conservative fixed-income investments as the child approaches college age.

The "account owner" is the individual entitled to select or change the designated beneficiary and to designate any person other than the designated beneficiary to whom funds may be paid from the account. The account owner also may retain the right to terminate the account and revest the account funds to himself or herself. For example, if a beneficiary decides not to go to college, the account owner can defer use of the account, change beneficiaries or withdraw the assets (subject to a 10% penalty). The account owner may not, however, directly or indirectly participate in investment decisions regarding a Section 529 account.

Some states permit persons other than the account owner to contribute to an education savings account or permit a change in the identity of the account owner. Therefore, the account owner is not always necessarily a contributor.

Income Tax Consequences. Earnings on a Section 529 account are not taxable to the account owner or the designated beneficiary. Generally, distributions from the account for qualified higher education expenses are not included in the account beneficiary's gross income. There is no adjusted gross income limit for participating in a Section 529 program.

Withdrawals that are not used for qualified higher education expenses are subject to income tax and will be assessed a 10% penalty. If the beneficiary receives a scholarship, however, the investor may withdraw the amount of the scholarship without penalty. Penalty-free withdrawals are also allowed in the event of death or permanent disability of the beneficiary.

Gift Tax and GST Tax Consequences. A contribution to a qualified tuition program is treated as a completed gift and may be subject to gift tax. All contributions are entitled to the $13,000 gift tax annual exclusion and also are exempt from GST tax if made within the gift tax annual exclusion limit. The contributor can contribute up to $55,000 ($110,000 if gift-splitting between spouses is elected) in one calendar year without making a taxable gift. That portion of the contribution in excess of the annual gift tax exclusion amount can be taken into account ratably over 5 years beginning with the calendar year of contribution. The election must be made on the donor's Federal Gift & Generation-Skipping Transfer Tax Return (Form 709). Generally, no distribution from a qualified tuition program is treated as a taxable gift.

A rollover to an account for a new beneficiary or a designation of a new beneficiary will not be subject to gift tax or GST tax if the new beneficiary of the account is a member of the family of the previous beneficiary and is in the same generation as the previous beneficiary.

Estate Tax Consequences. Despite the account owner's right to change the beneficiary or terminate and revest the account, the account assets are excluded from the account owner's gross estate for federal estate tax purposes. The value of the account is, however, included in the gross estate of the account's beneficiary for estate tax purposes. If a contributor elects to spread excess contributions over 5 years, the portion of the excess contributions allocable to calendar years beginning after the contributor's date of death will be included in the contributor's gross estate for federal estate tax purposes.

Financial Aid. A Section 529 prepaid tuition plan is considered a resource of the student that reduces a student's financial need on a dollar-for dollar basis. Therefore, a student's eligibility for subsidized loans, work-study or certain grants may be reduced. A Section 529 education savings account is treated as an asset of the account owner (usually the parents) for financial aid purposes. Therefore, if the student is not the contributor, the account does not count as an asset of the student.

Education IRAs (Coverdell Education Savings Accounts)

Another device for contributing to a child's education is an Education IRA, now called a Coverdell Education Savings Account. An Education IRA is created to pay "qualified education expenses" of the designated beneficiary. "Qualified education expenses" include "qualified higher education expenses" and "qualified elementary and secondary education expenses." "Qualified higher education expenses" include tuition, fees, books, supplies and equipment required for the enrollment or attendance of a beneficiary at a post-secondary educational institution. They also include contributions to a qualified tuition program on behalf of the beneficiary. Qualified higher education expenses may include room and board if certain requirements are met.

"Qualified elementary and secondary education expenses" include tuition, fees, academic tutoring, books, supplies, computer equipment and other equipment in connection with the enrollment of the beneficiary at a public, private or religious school. They also include room and board, uniforms, transportation, and the purchase of computer technology or equipment or internet access if these are to be used while the beneficiary is in school.

Limits on Contributions. A donor may make nondeductible cash contributions to an Education IRA of up to $2,000 a year for each beneficiary. The $2,000 limit applies in the aggregate to all Education IRAs for the same beneficiary.

The amount that a married couple filing jointly can contribute to an Education IRA is phased out between $190,000 and $220,000 of adjusted gross income. Contributions to an Education IRA must be made in cash and cannot be made after the beneficiary reaches age 18. The account may remain open, however, until the child turns 30, at which time any balance remaining in the account must be distributed.

Income Tax Consequences. Contributions to an Education IRA are not tax deductible. Earnings on contributions to an Education IRA, however, are not taxed when earned. If distributions equal the amount of qualified education expenses, then the distributions are not included in the beneficiary's gross income. If the amount of distributions exceeds the qualified education expenses during the taxable year, then the earnings portion of the distribution will be included in the beneficiary's gross income. Additionally, with limited exceptions, there is a 10% penalty imposed to the extent that a distribution from an Education IRA is includible in gross income. When a beneficiary reaches age 30 and the account is distributed, the earnings portion of the distribution will be included in the beneficiary's gross income and subject to an additional 10% penalty because the distribution is not for education.

A distribution to an Education IRA that is rolled over into another Education IRA for the benefit of the same beneficiary or a member of the beneficiary's family who has not reached age 30 is excluded from income. Additionally, a change in the beneficiary is not treated as a distribution if the new beneficiary is a member of the family of the old beneficiary and has not reached age 30.

Gift Tax and GST Tax Consequences. A contribution to an Education IRA is a completed gift and qualifies for the gift tax annual exclusion and exemption from GST tax. Generally, no distribution from an Education IRA is treated as a taxable gift.

A rollover to an account for a new beneficiary or a designation of a new beneficiary will not be subject to gift tax or GST tax if the new beneficiary of the account is a member of the family of the previous beneficiary and is in the same generation as the previous beneficiary.

Estate Tax Consequences. Generally, the value of the Education IRA is not included in the gross estate of the donor. Amounts distributed on account of the death of the designated beneficiary are included in the beneficiary's gross estate.

Financial Aid. An Education IRA is considered an asset of the designated beneficiary for financial aid purposes.

Conclusion

Each of the options for making gifts to minors has advantages and disadvantages, and the best option will depend upon which factors are most important to the individual donor.

Gifts to a minor in a custodial account are uncomplicated. Once the child turns 21, however, all property in the account must be distributed to the child outright. Further, significant assets in such an account could reduce the child's eligibility for financial aid for college.

Although a Section 2503(c) trust must give the beneficiary the right to withdraw all of the trust property at age 21, the trust instrument may be written so that the beneficiary must take affirmative action to terminate the trust and has a limited amount of time to do so. Thus, it is possible that the beneficiary could be convinced to leave the property in the trust until the time the donor has decided the donee should have a right of withdrawal.

With a Crummey trust, there is no requirement that the beneficiary have the right to terminate the trust at age 21, so the donor may structure the trust to last essentially as long as the donor wishes. The beneficiary or the beneficiary's parent or guardian must have the right to withdraw the value of each gift to the trust for a short period of time following the gift. Therefore, if the donor feels the beneficiary or the parent or guardian of a minor beneficiary might exercise these withdrawal rights, the benefit of making the gifts in trust would be defeated.

If a donor wishes to make gifts that are to be used exclusively for the child's education, then the donor should consider a Section 529 Qualified Tuition Program or Education IRA. Distributions from an Education IRA are income tax-free if used entirely for education expenses, but contributions are limited to $2,000 a year per child, and there is an adjusted gross income limit of $220,000 a year for married couple participants. Plus, as with a custodial account, an Education IRA could count against the child when it comes to applying for financial aid.

Anyone may participate in a Section 529 plan, and a donor may contribute the entire federal annual gift tax exclusion amount, if desired. The account owner retains control over the assets even after the beneficiary reaches the age of majority, but the account assets are excluded from the account owner's taxable estate. The account owner also may retain the right to terminate the account or to change the beneficiary. Finally, earnings on a Section 529 account will not be taxed to the account owner or the designated beneficiary as long as the withdrawals from the account are used for qualified higher education expenses.

Although the information provided herein should assist a donor in selecting the manner in which he or she would like to make a gift to a minor child, the donor will require more information and assistance in order to follow through with the making of the gift. Sonnenschein Nath & Rosenthal can advise the donor and assist the donor in completing any such transaction.

The following chart summarizes characteristics of these plans. The chart is a generalization and does not intend to thoroughly cover the topics listed.

	§ 2503(e)	**529 Plans**	**Coverdell ESA (Education IRA)**
Ownership/Control of Account	Donor.	Donor.	Donor controls on behalf of the beneficiary.
Guidelines for Use	Must be for tuition paid to a qualifying educational institution or payment to a provider for medical care under § 213(d).	Qualified higher education expenses at participating accredited post-secondary schools anywhere in the U.S.	Must use for qualified elementary, secondary or higher education expenses by the time beneficiary turns 30.
Annual Contribution Limit	Unlimited and in addition to gift tax annual exclusion.	Unlimited but amount over the annual exclusion subject to gift tax. Contribution greater than annual exclusion may be ratably taken over 5 years.	$2,000 per designated beneficiary under 18.
AGI Limit	None.	None.	Single: $95-110K Joint: $190-220K
Taxation of Earnings	Not applicable.	Tax-free growth. Qualified distributions are federal income tax-free. State tax varies.	Tax-free growth. Qualified distributions are federal income tax-free. State tax varies.
Taxation/Penalty Upon Early Withdrawal	Not applicable.	Earnings portion of nonqualified withdrawals taxed as ordinary income and subject to federal 10% penalty.	Earnings portion of nonqualified withdrawals taxed as ordinary income and subject to federal 10% penalty.
Gift and GST Consequences	Not subject to gift tax or GST tax.	Subject to gift and GST tax; however, the use of the gift tax annual exclusion is permitted.	Subject to gift and GST tax; however, the use of the gift tax annual exclusion is permitted.

	§ 2503(e)	529 Plans	Coverdell ESA (Education IRA)
Estate Tax Consequences	Not included in estate of donor or beneficiary.	Included in beneficiary's estate, but not included in donor's estate.	Included in beneficiary's estate, but not included in donor's estate.
Change of Beneficiary	Not applicable.	Can transfer account penalty-free to benefit member of beneficiary's family.	Can transfer account penalty-free to benefit member of beneficiary's family.
Financial Aid	Not counted as a resource for student or parent.	Pre-paid tuition program - student resource. 529 Account - included in calculating parental contribution, not a student resource.	Student resource.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information regarding lifetime gifts to minors or any other estate planning options.