



Roth IRA Advisor

# E-mail Newsletter

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ACCUMULATE WEALTH AND REDUCE TAXES

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Roth IRA Advisor Newsletter Edition 8:

## Options for Making Gifts to Minor Beneficiaries

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Various factors motivate us to make gifts to minor children. The primary estate-tax motivation is to remove assets (plus the appreciation ) from our taxable estates during our lifetime. (Please read *Planned Gifting* in our newsletter archives.) Another tax motivation is to shift income-producing property to a child or grandchild who may be taxed in a lower income tax bracket. While favorable tax consequences provide a strong inducement for making a gift to a minor child, various non-tax factors typically shape the form the gift takes.

Two basic methods for making a gift to a minor are discussed in this article: (1) a transfer to a Custodian under the Uniform Transfers (or Gifts) to Minors Act; and (2) a transfer to a so-called Crummey Trust.

### Uniform Transfers to Minors Act

Laws have been enacted by all 50 states to facilitate gifts to minors. In Pennsylvania, the law is the Uniform Transfers to Minors Act (“UTMA”). Differences among the various state laws do exist, however, they are generally variations on a common theme. UTMA governs lifetime transfers of money, securities, life insurance policies and annuity contracts to minors.

*Advantages of an UTMA.* The main attraction of UTMA is its simplicity and cost-effectiveness. Creating and maintaining the account is relatively easy, and there is no need to hire an attorney. The fees to set up an UTMA account are generally nominal. Virtually all financial institutions (such as TIAA-CREF, Vanguard, Paine Webber, Merrill Lynch, virtually all banks, etc.) can establish UTMA accounts. The donor gives the property to a designated adult as the “custodian” who holds the property for the benefit of the minor beneficiary. The custodian then controls the property until the minor reaches either 18 or 21 years of age, depending upon the jurisdiction (21 years of age for Pennsylvania).

*Disadvantages of an UTMA.* There are three distinct limitations associated with an UTMA account:

1. If the donor is also the appointed custodian, and such donor dies before the minor beneficiary attains age 21, the transferred property is included in the donor's gross estate for federal estate tax purposes. (See discussion below.)
2. The custodian's control over the transferred property only lasts until the minor reaches 21 years of age (at which time they are still relatively inexperienced in financial matters).
3. If the minor is under the age of 14, the "kiddie tax" rules apply as to income earned within the UTMA account. (See the brief note below regarding the "kiddie tax" rules.)

*Estate Tax Consequences.* A strategic error many donors make is to create UTMA accounts and name themselves as the custodian of the property. These donors incorrectly believe the gifted property is effectively removed from their own estate. This is a common mistake. Internal Revenue Code (Code) Section 2038 provides that your gross estate includes the value of all transferred property over which you still retain control at the time of your death. Control for this purpose is defined as the power to alter, amend, revoke, or terminate the enjoyment of the beneficial interest in the property. Under IRS Revenue Rulings 70-348 and 57-366, the value of property that you transfer to yourself, pursuant to UTMA, as custodian for a minor donee, will be included in your gross estate for federal estate-tax purposes if you die before the minor's 21<sup>st</sup> birthday.

*Jim Lange's Commentary:* *This ruling is outrageous. Even though the custodian has physical control of the funds, the custodian is required by law to act in accordance with a strict fiduciary duty to protect the interest of the minor child. The custodian may not use the money for anything other than the minor's benefit. Why should money that has been irrevocably transferred to a minor, money that can only benefit the minor, be included in the estate of the donor/custodian? Unfortunately, as practitioners, we don't make the laws, nor do we attempt to change the laws. Instead, we attempt to arrange our client's affairs to their best advantage using existing laws.*

In the event that you are already the custodian of an UTMA account in which you are also the transferor, you may want to change the account so that someone else is

the custodian. You may designate a successor custodian at any time. There are three steps required for the appointment of a successor custodian:

1. Execute and date a written instrument designating a successor custodian in the presence of a subscribing witness other than the appointed successor,
2. Prepare a written notice of resignation; and
3. Deliver these documents (as well as the custodial property) to the successor custodian and the applicable financial institution.

“Kiddie Taxes.” The “kiddie tax” rules also apply to UTMA accounts if the respective minor beneficiary is under 14 years of age. The rules provide that the unearned (i.e., investment) income of such child in excess of \$1,400 per year will be subject to tax at the parent’s higher tax rate.

### **Alternatives to UTMA Accounts**

One major advantage of a formal trust arrangement over an UTMA account is the ability to postpone the distribution of trust principal until a more comfortable age, such as a schedule which permits payment of equal shares at ages 25, 30 and 35. Donors can be much more confident that the long-term use of the trust funds will be better protected in this type of scenario given the presumed maturity of the beneficiary over this extended period of time.

For example, if you planned on giving \$20,000 per year to a newborn grandchild, the principal would be almost \$850,000 by the time the grandchild reaches age 21 assuming a 6.0% after-tax growth rate. Would you want to give a grandchild unrestricted control of that much money at age 21 (as would result with an UTMA)? Or even half that much?

### **Crummey Trust for Minors**

An alternative to an UTMA account that enables a donor to postpone distributions of the gifted property beyond age 21 and retain all of the gift and estate-tax advantages discussed above, is the so-called “Crummey Trust.” This type of trust can be used to defer distribution of the trust property for as long as desired without forfeiting the benefits of the annual gift tax exclusion. Each time a trust contribution is

made, each beneficiary (or their guardian if the beneficiary is under age 18) must be notified of the beneficiaries *right to withdraw* the contribution for a limited period of time, such as 30 days (of course, with the expectation that the beneficiary will not actually exercise their withdrawal option). This withdrawal notification is the IRS' way of qualifying the trust contribution for the "present interest" necessary in order for the \$10,000 gift tax exclusion to apply. Although this notice requirement may seem relatively minor, it is extremely important that it is diligently performed. Otherwise, there can be drastic negative gift and estate tax consequences.

Unfortunately, if you have already set up an UTMA account, you cannot presently transfer or convert it to a Crummey Trust. Transfers under UTMA are irrevocable. However, for future planned gifts you should now be able to make an educated decision as to which type of gift funding vehicle best suits your needs and intentions.

## CONCLUSIONS

To transfer property to an UTMA account in such a manner that it will not be included in your estate, choose an adult custodian other than the donor (such as another trusted family member). If you are already the custodian of an UTMA account in which you are also the transferor, you should consider designating a new custodian by completing the procedures outlined above.

If you want to defer a beneficiary's access to the transferred property beyond age 21, then a Crummey Trust is a superior gift-funding vehicle. A Crummey Trust is more difficult to administer than an UTMA account. However, the additional administration required by a Crummey Trust may be a small price to pay for the advantages of being able to serve as trustee, without having the trust property included in your estate and the ability to postpone distributions to a beneficiary until a more appropriate age than 21.

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