MEMORANDUM

GIFTS TO MINORS

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The purpose of this memorandum is to describe several arrangements for making gifts to minor children or grandchildren. Each arrangement qualifies the gift for the annual $14,000 gift tax exclusion, ($28,000 for a split gift by spouses). This memorandum will contain an overview of each arrangement, and will describe the advantages and disadvantages of each. The five alternate arrangements are: outright gifts; gifts under the Kansas Uniform Transfers to Minors Act; gifts to an Internal Revenue Code Section 2503(c) Trust, ("§2503(c) Trust"); gifts to an irrevocable trust with a "Crummey" withdrawal provision; and gifts to a Section 529 Plan. The technique or techniques you select will depend on your tolerance for complexity, potential tax implications, and the degree of control you wish to maintain over the gifted property.

We are required by the Internal Revenue Service to advise you that although our conclusions are based on substantial authority and relate to tax benefits in a manner consistent with applicable statutes and Congressional intent, they are not intended to be relied on and cannot be relied on for the purpose of avoiding penalties that may be imposed by the Internal Revenue Service.

Outright Gifts

The outright gift is the simplest of the four options to execute, as it only entails a direct transfer of property or money to the minor. Once the transfer to the minor is made, the minor owns the property outright. Although simple in execution, this simplicity can be outweighed by several disadvantages that are contrary to the goals of most donors who desire to make gifts to minors.

The primary disadvantage of an outright gift is that the donor has allowed control of the gifted property to pass into the hands of a minor, who is restricted by law in his ability to enter into a contract regarding the property and who may not have the maturity to manage the property. In addition, if a minor should die before attaining the age of majority, the minor's assets will most likely pass to the parents under intestate laws, as minors are incapable of executing valid wills. This nullifies the benefit of utilizing the annual gift tax exclusion, as the gifted amounts, to the extent that they remain at the minor's death, will be included in the donor's estate for estate tax purposes.

Kansas Uniform Transfers to Minors Act

Under the Kansas Uniform Transfers to Minors Act ("UTMA"), the donor executes a gift by transferring title to property to a UTMA account in the name of a custodian for the minor (donee). Unlike an outright gift, the UTMA allows the donor to prevent the donee from obtaining outright ownership of the gifted property until the donee reaches twenty-one years of age. Upon reaching twenty-one years of age, all of the property in the UTMA account must be distributed to the donee.

A donor may appoint himself or herself as custodian, but this is not advisable, as

estate tax consequences can arise. Therefore, the donor should select a relative or close friend to serve as custodian. The duty of the custodian is to hold and administer the property in the UTMA account for the donee until the donee reaches the age of twenty-one. At least one successor custodian also should be named. The custodial property is created by causing the asset transferred to be registered or designated in the name of the custodian followed in substance by the words "as custodian for __________________ (name of minor) under the Kansas Uniform Transfers to Minors Act." Although there are other methods for creating custodianships under the Uniform Transfers to Minors Act, using the words designated will generally be sufficient.

The custodian may distribute principal and income to the minor prior to the minor attaining the age of twenty-one. But, if the custodian makes distributions to the minor to satisfy obligations for which the parents are responsible, such as living expenses, the amount distributed will be included as income to the parents. This being the case, it is often wise to advise the custodian to only make distributions for educational related expenses.

A UTMA account has fewer administrative requirements than a §2503(c) trust or a Crummey trust, as it does not require a formal trust document and is not considered a fiduciary account; therefore, an income tax return is not required to be filed on behalf of the UTMA account. Instead, all of the income is reported directly by the beneficiary, whether distributed or not.

Because all of the income from a UTMA account is taxed to the beneficiary, the

"kiddie" tax can cause additional tax concerns. The kiddie tax requires unearned income of a child under 18 years of age to be taxed at the marginal income tax rate of the child's parents, instead of the child's rates to the extent that unearned income exceeds the child's standard deduction of $1,700. The following example illustrates the effect of the kiddie tax.

Example. Assume that a UTMA account has $10,000 of income during the year, the donor's parents have a marginal tax rate of 35% and the beneficiary is under the age of 18. The beneficiary is limited to a $1,900 deduction under the kiddie tax rules. Therefore, $1,900 is protected from any tax liability, but the remaining $8,100 is subject to the 35% marginal tax rate of the parents. The resulting tax liability is $2,835.

When the beneficiary reaches the age of 18, the beneficiary is no longer subject to the kiddie tax rules; therefore, the beneficiary's standard deduction will be $5,450. This will enable the trustee to shield $5,450 from income tax liability. The remaining $4,550 will be taxed to the beneficiary and subject to the a tax rate of 10%. This produces a tax liability of $455.

As the example illustrates, the incentive to minimize current income is the greatest when the minor is less than eighteen years of age. Regardless of the minor's age, the income tax effect can be eliminated by reducing the current income generated by the UTMA account. This can be accomplished by ensuring the UTMA account holds assets that minimize current income in favor of growth. Examples include various forms of life insurance, as well as most stocks and mutual funds.

Like an outright gift, a disadvantage that exists with the use of a UTMA account

is that the UTMA account will probably revert back to the parents if the minor dies before attaining the age of majority.

Section 2503(c) Trusts

Generally, gifts to a trust do not qualify for the annual gift tax exclusion, as the minor (beneficiary) does not have control over the property at the date of the gift. Gifts to a minor in a §2503(c) trust are an exception and qualify for the annual gift tax exclusion if the following conditions are satisfied:

1. The trust principal and income may be paid to the beneficiary or spent for the benefit of the beneficiary prior to the beneficiary reaching the age of twenty-one;

2. Any amount remaining in the trust when the beneficiary reaches twenty-one years of age must be distributed to the beneficiary; and

3. If the beneficiary dies before reaching twenty-one years of age, any amount remaining in the trust is either paid to the beneficiary's estate or passes under a general power of appointment granted to the beneficiary.

Use of a §2503(c) trust may allow the donor greater flexibility and control over the gifted property as compared to a UTMA account. This added control and flexibility comes with a price, namely increased administrative requirements, such as the drafting of a formal trust document and the filing of an income tax return on behalf of the trust. One of the initial steps taken by the donor is the selection of a trustee. A donor can appoint himself as trustee, but this is discouraged due to the same estate tax concerns that result when the donor serves as custodian of a UTMA account. A friend or relative

is usually the best choice to serve as trustee.

Although one of the conditions of a §2503(c) trust is that the trust assets be distributed upon the beneficiary reaching age twenty-one, the trust may continue until a later date (generally thirty years of age) if the beneficiary does not withdraw the trust assets within a reasonable period of time (generally thirty days) after the beneficiary attains age twenty-one. The trust can, therefore, continue until the beneficiary reaches a more mature age. No such continuation is possible with an UTMA gift. A beneficiary who does not exercise his or her right to withdraw during the thirty day period is treated as the grantor of the trust for the remaining term. Consequently, the beneficiary is required to include all of the trust income in the beneficiary's income tax return, as contrasted from the trust's separate identity for income tax purposes prior to the time the beneficiary attains age twenty-one.

The primary advantage of a §2503(c) trust is the discretion given to the trustee in deciding whether to distribute income or let the income accumulate within the trust. The donor can provide some guidance on the type of expenses for which income can be distributed to the beneficiary. For instance, the trust can provide that the trustee only distribute funds for the beneficiary's "support, education, maintenance, and health." But, even with the former provision, a trustee has the ultimate decision regarding distributions.

A §2503(c) trust is considered a separate taxpayer from the beneficiary. Although this may increase administrative complexity due to the filing of a fiduciary income tax return, the trustee can allocate the trust income between the beneficiary and the trust to minimize the potential tax liability. The donor can provide added protection over the income distributed to the beneficiary by requiring the trustee to distribute income to the custodian of a UTMA account in the name of the beneficiary.

Example. Assume that a §2503(c) trust has $10,000 of income during the year, the donor's parents have a marginal tax rate of 35%, and the beneficiary is under the age of 18. The beneficiary is limited to a $1,900 deduction under the kiddie tax rules. Therefore, the trustee would distribute $1,900 to the beneficiary, resulting in a zero tax liability. The trust would keep the remaining $8,100. The trust is provided with a $100 standard deduction, which exposes $8,000 of income to the tax rates of the trust, which reach 33% when taxable income exceeds $7,400. If the $8,000 were distributed to the beneficiary, the entire amount would be subject to a tax rate of 35% because of the kiddie tax rules. The resulting tax liability of distributing $1,900 to the beneficiary and retaining the remaining $8,100 in the trust is $1,906.

Assume the trust has income of $10,000 when the beneficiary reaches the age of 18. The beneficiary is no longer subject to the kiddie tax rules; therefore, the beneficiary's standard deduction will be $5,450 This will enable the trustee to shield $5,450 from income tax liability by distributing it to the beneficiary. The trustee will again take advantage of $100 standard deduction afforded the trust. The remaining

$4,450 will be distributed to the beneficiary, as the beneficiary does not reach the 25% tax bracket until he or she receives $30,650 of additional income, whereas, the trust reaches the 25% tax bracket upon receiving $2,050 of income. This results in a tax liability of $445.

The tax liability after the beneficiary reaches eighteen is approximately the same under the UTMA account or a §2503(c) trust, but there is a $929 savings by using a §2503(c) trust, rather than a UTMA account if the beneficiary is under the age of eighteen. This is due to the trustee's ability to split income between the trust and the beneficiary.

As previously mentioned, the consequences that arise due to the existence of trust income can be eliminated by funding the trust with assets that minimize current income and emphasize principal appreciation. If the trust does not have any income, the income tax filing requirements are avoided and the kiddie tax implications are eliminated. In addition, if the trust is funded with life insurance, the trust will be provided with additional funds to satisfy the beneficiary's educational needs should the donor die prematurely.

A §2503(c) trust may also structured as a so-called "grantor trust." A grantor trust is a trust in which the grantor or person who establishes the trust retains certain powers that cause the trust's income to be taxed to the grantor but not taxed in the grantor's estate for federal estate tax purposes. The principal benefit of a grantor trust is that the grantor is taxed on the income from the trust, which in effect constitutes an

indirect gift to the trust's beneficiary in that it permits the trust to grow income tax free. The trust can be drafted so that the grantor trust status is toggled off by an independent trustee so that if circumstances change or the grantor no longer desires to be taxed on the income from the trust, an independent trustee can either reimburse the grantor for the income tax consequences or terminate the grantor trust status. In either event, the grantor would no longer have the burden of being taxed on the trust's income, and that income would either be taxed to the trust beneficiary or the trust itself.

Irrevocable Trust with "Crummey" Withdrawal Provisions

Donors may also qualify their gifts for the annual gift tax exclusion by utilizing an irrevocable trust with "Crummey" withdrawal provisions. The Crummey trust qualifies the gift by enabling the beneficiary to withdrawal the gift for a limited period of time (usually thirty to sixty days) after the date of the gift. If the beneficiary does not exercise his or her withdrawal power, the power lapses and the gift remains a part of the trust until the trust terminates.

The Crummey trust has many characteristics in common with a §2503(c) trust. Some of the most prominent similarities are the following:

1. Trustee has broad discretion to pay or withhold income and principal;
2. The trustee must file a separate tax return on behalf of the trust; and
3. Trust assets do not revert to the beneficiaries parents upon the death of the minor beneficiary, as the donor can utilize a general power of appointment.

The principal advantage of a Crummey trust, as compared to a §2503(c) trust is that a Crummey trust need not terminate when the beneficiary reaches twenty-one years of age. Instead, the trust continues as long as the trust instrument provides. This is advantageous to donors who wish to keep a beneficiary from gaining control of the trust assets at the age of twenty-one. In addition, gifts made to a Crummey trust are eligible for the annual gift tax exclusion, regardless of the beneficiary's age. Another advantage of the Crummy trust is that a single trust can be utilized for multiple beneficiaries, whereas, a §2503(c) trust can only have one beneficiary.

Several disadvantages also exist. First, as previously mentioned, the beneficiary has the power to withdraw gifts from the trust for a reasonable period of time after the gift is made. This may not be a significant problem though, as a beneficiary who chooses to withdraw a gift in opposition to the donor's wishes could be in jeopardy of not receiving future gifts. Second, Crummey trusts carry a great administrative burden due to the notices that are required to be sent to the beneficiaries at the time of each gift. Finally, there is a general dislike of Crummey trusts by the Internal Revenue Service. An irrevocable trust with Crummey withdrawal provisions can also be structured as a grantor trust in the same manner as described under the explanation of the §2503(c) trust, found on page 8.

Section 529 Plan

A qualified state tuition program ("529 Plan") is an investment account program established and maintained by a state agency which is designed to pay for "qualified

higher education expenses." Qualified higher education expenses include tuition, room and board, fees, books, and supplies required for attendance at a post-secondary educational institution. A 529 Plan account can be established under any state program and distributions from the 529 Plan account may be used for educational expenses at almost any accredited post-secondary school in the United States; however, restrictions and state tax consequences may vary from state to state.

The primary benefits of a 529 Plan are that the income generated in the account is exempt from federal income tax and therefore, the earnings on contributions may grow tax-deferred. A donor may make gifts to a 529 Plan account that qualify for gift and generation-skipping transfer tax annual exclusions even though the donor retains the right to decide when and to whom distributions are made and may reacquire the funds at any time. A donor may contribute up to $65,000 per donee ($130,000 for a split gift by spouse) and average such gift over a five year period thereby front-loading the contribution to take advantage of the tax-exempt growth of the earnings. The account owner is the person who controls the 529 Plan account and generally may select or change the designated beneficiary, decide when distributions are to be made, and designate a person other than the designated beneficiary to receive distributions from the account. The owner may change the beneficiary of the account with no federal tax consequences if the new beneficiary is a member of the family of the old beneficiary and is not in a generation lower than the previous beneficiary. The value of the 529 Plan account at the time of the owner's death is not included in the owner's estate for

federal estate tax purposes, except for the portion of any five year gift if the owner dies before the end of the five years.

Contributions to a 529 Plan account can only be made in cash and the owner is restricted to the investment options offered in the particular state's 529 Plan. One disadvantage of a 529 Plan is that the funds may be used only for post-secondary education in order for the earnings to remain tax-exempt. If the funds are distributed to the beneficiary but not used for qualified educational expenses, the earnings portion of the distribution is subject to income tax at the beneficiary's tax rate and subject to a 10% penalty. The funds in the account may also be returned to the owner subject, however, to income tax at the owner's tax rate and a 10% penalty on the earnings portion of the distribution.

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