



FERRIS FINANCIAL, LLC

HELPING YOU PLAN, PROTECT & PROSPER



## Overview

Helping a child with his or her education or support often requires gifts. Fortunately, there also may be income and estate tax savings to making gifts to minor children. Gifts can be made directly or indirectly to a child, or to a trust for his or her benefit.

## Description and Operation

### *Gifts*

Gift taxes may be imposed on other transfers to minors (or others). Each person currently has an "annual gift tax exclusion" of \$15,000 (in 2018, as indexed for inflation) per recipient per calendar year. In addition, each person may gift up to their "applicable exclusion amount", as indexed for inflation (\$11,180,000 in 2018), during life without triggering gift tax.

### *Kiddie Tax*

The "kiddie tax" curtails the ability of parents to significantly lower their family's tax bill by transferring investment assets to children who may be at lower marginal income tax brackets. The kiddie tax rules apply to children who have at least one parent alive and who are (i) under age 18 or (ii) at least 18 but not yet 19 (or not yet 24 in the case of a child who is a fulltime student) and whose earned income for the tax year does not exceed one-half of the child's support.

In 2018, the first \$1,050 of a child's unearned income is tax free because it is offset by the standard deduction, the second \$1,050 of unearned income is taxed to the child at his/her tax rate, and any unearned income over \$2,100 is taxed at the parents' tax rate. Because the kiddie tax disappears after a child turns 24, many parents give their children investments that defer income until the kiddie tax no longer applies.

### *Gifts for Educational and Medical Expenses*

A gift to pay for a donee's educational or medical expenses does not constitute a taxable gift if made directly to the provider of the services. The direct payment of educational expenses only covers tuition paid directly

to the educational institution, not books, room and board, etc. Medical expenses include expenses of "medical care" described by IRS regulations.

### ***Custodianships***

Direct gifts can occur to a minor under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA).<sup>1</sup> The transfer instrument must declare that the property is transferred to the custodian "as custodian for" the minor. The UGMA account terminates when the minor reaches the age of majority, while an UTMA account must be distributed when the beneficiary reaches 21. Dispersing a large sum of money to an 18-year-old (the age of majority in most jurisdictions) or 21-year-old may be problematic. For estate tax purposes, the donor should not be the custodian, because the property could be included in the donor's estate if the donor-custodian predeceases the donee.

### ***Traditional Irrevocable Crummey Trust***

Parents and grandparents wanting to make a substantial gift to a child should consider establishing an irrevocable trust. Gift tax may arise to the extent annual and lifetime exclusion gifts are insufficient. In order to take advantage of the annual exclusion, Crummey powers may be used. The beneficiary may exercise Crummey withdrawal rights through a parent or guardian. The trustee may be given the power to pay income and principal to the beneficiary.

### ***Irrevocable Minor Trust 2503(c)***

If only a modest sum will be available to the child at age 21, or if the principal will most likely be exhausted before the trust will terminate, a minor's trust may be appropriate.

Under Internal Revenue Code Section 2503(c), a gift to a trust established for a minor qualifies for the gift tax annual exclusion if the child has the right to withdraw the money at age 21. However, a child can be granted the right to continue the trust term beyond age 21. This trust essentially enables a parent (or grandparent or other individual) to transfer property that would be subject to income or estate taxes into a trust that is taxed separately. The principal and any interest earned can be used for the child's benefit, such as for college expenses.

In order to be a valid 2503(c) Trust, the trust must: (1) have only one beneficiary; (2) make income and principal available to the trustee for the benefit of the child during the term of the trust; and (3) if the child dies before age 21, distribute the assets to his or her estate.

In some states, an UTMA custodian can transfer the assets to a minor's trust that permits the assets to remain in trust until the beneficiary is older. The beneficiary will have the unrestricted right to withdraw all trust assets for a reasonable period of time (for example, 60 days) on reaching age 21. But if the beneficiary doesn't exercise that right within the allotted timeframe, the assets will remain in trust and can no longer be withdrawn. Once the withdrawal right expires, assets will remain in trust unless distributed at the trustee's discretion or as prescribed in the trust instrument. There is no guarantee that this strategy, however, will retain the assets in trust after the beneficiary reaches age 21.

### ***Irrevocable Minor Trust 2503(b)***

This variation of the 2503(c) trust creates a "present interest" by requiring that all income from the trust be distributed annually. The distribution of income can be made to the child directly or to a custodial account where it can be accumulated or used for the child's benefit. The principal can be held in the trust until after

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<sup>1</sup> 48 states have adopted the more recently developed UTMA, while Vermont and South Carolina still operate under the UGMA.

the child reaches age 21. The key difference between a 2503(c) trust and a 2503(b) trust is the distribution requirement. Parents who are concerned about providing a child or other beneficiary with access to trust funds at age 21 might be better off with a 2503(b), since there is no requirement for access at age 21. In fact, assets may be held long into the child's adulthood. The main disadvantage to a 2503(b) trust is that the annual distribution requirement may limit growth of the trust principal.



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