

## **MAKING GIFTS TO KIDS**

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There are right ways and wrong ways to make gifts to kids. Although tax savings often motivate gifts to kids, the important considerations are practical. Here are few things to think about.

### **gifts to kids – practical considerations**

Consider a life insurance policy made contingently payable “to my children in equal shares” (if the insured’s wife does not survive). This simple estate plan, made out in the insurance agent’s office, may do more harm to the insured’s estate than if the insured had not purchased any life insurance. This is because each child will be able to take his share of the insurance on his 18<sup>th</sup> birthday, whether or not sufficiently mature to handle such large sums of money, leaving a substantial risk that the insurance will be misspent and used to subsidize a debauched lifestyle (college drop-out, fast cars drugs, etc). Furthermore, equal gifts to children may not be fair. Assume it costs \$10,000 per year to raise a child. An insured and his wife die in an auto accident with 3 surviving children, ages 13, 8, and 3, as equal beneficiaries of a single \$300,000 life insurance policy. The 13 year old will be \$50,000 ahead, when he reaches 18 (the age of emancipation, not necessarily the age of maturity); the 8 year old will break even at 18 and the 3 year old will be \$50,000 in the hole. *These amounts are used for simplicity of illustration and not to suggest that a \$300,000 life insurance policy would be adequate to care for such a family.* Or suppose one child needs an expensive medical procedure. Would anyone write a will that reduces the debilitated child’s inheritance by the \$50,000 used for the medical costs that his other siblings did not have to suffer? Whether through a revocable living trust or a testamentary trust (part of a will), contingent trusts for younger beneficiaries can prevent young children from prematurely inheriting and can effectively protect the children as a group, allowing them to share their economic risks as a group.

### **gifts to kids - tax considerations**

The federal tax code excludes gifts up to \$13,000 per year per donee (subject to an annual inflationary adjustment) from estate/gift taxation and without impairing a donor’s (giver’s) lifetime estate/gift tax “exemption” (now an aggregate of \$10,000,000 for life time and at death gifts). A husband and wife can each make \$13,000 gifts to the same donee, effectively doubling the excludable amount to \$23,000 per person. The annual exclusion also allows additional tax-free gifts for a donee’s education (tuition) and health care expenses.

When gifted funds are invested, they generate income that accumulates. In most cases, the income from the invested funds is taxable; sometimes taxable to the donor, sometimes taxable to the donee (the beneficiary), and sometimes to an entity (*e.g.* a minor’s trust). When a child is under the age of 14, his “unearned income” will be subject to “kiddie tax” rates (the highest tax bracket of his parents).

### **types of lifetime gifts**

In addition to gifts made to kids taking effect at death (through a living trust or a will), there are various ways of making immediate (lifetime) gifts to kids. Among them are: joint tenancies with right of survivorship, guardianships/conservatorships, custodial accounts, minor's trusts, Crummey trusts, and various education savings accounts.

### **joint tenancies with right of survivorship**

Frequently donor will deposit \$13,000 in a new bank account naming himself and his grandchild as joint owners. Other than for saving attorney's fees, this simple gift has serious disadvantages. First, the gifted funds will remain taxable in the donor's estate, when the donor dies. Second, there is no guarantee that when the grandchild becomes 18, he won't clean out the account, buy a new sports car, and not go to college or buy a new home as the donor had hoped. This travesty will more likely occur if the donor dies before the grandchild matures. Third, if the donor dies before the grandchild becomes 18, the bank will require a court-appointed guardian or conservator to control the funds until the grandchild becomes emancipated (upon marriage or reaching age 18).

### **guardianships/conservatorships**

Guardianships and conservatorships are judicially imposed arrangements, used for protecting a minor's property. The laws of the state of Montana govern when and how these funds can be used for a minor. When the minor becomes 18, all of these funds have to be paid directly to the child (unless the child is incompetent). These judicially imposed arrangements have the advantage of court scrutiny but the disadvantage of continuing legal expenses and inflexibility in what can be done with the funds.

### **custodial accounts**

Under the Montana's Uniform Transfers to Minors Act, a donor can deposit funds in a custodial account for the benefit of a minor. These accounts require less formality than a guardianship/conservatorship. When the minor reaches age 21 (in some cases age 18), the funds must be distributed to the minor. The custodian is accountable to the minor for any abuse. But if the custodian has stolen or wasted all of the funds, is dead, or is broke, a lawsuit will be futile. The donor does not have to pay anything for setting up the account. The income from a custodial account will be taxed to the child, subject to kiddie tax rules (explained above).

### **Minor's trusts**

A irrevocable gift in trust to a child under age 21 will qualify as a tax excludable gift as long as the child has a right to the funds by the time he reaches 21 (not 18). All distributions to the minor will be taxed to him and subjected to the unpleasant "kiddie tax rates" (if under 14). Any income accumulated in a minor's trust is taxable to the trust (as opposed to a custodial account) and subjected to trust tax rates, which are worse than individual tax rates!

### **Crummey trusts**

This Crummey trust was named after a taxpayer named “Crummey.” The trust is not crummy. A gift to Crummey trust will qualify as a tax excludable gift, even if the beneficiary’s access to the gifted property can be effectively deferred until the beneficiary becomes mature (*e.g.* age 25, 35, 45, or even older). The Crummey trust meets the “present interest rule” for tax excludable gifts by giving the beneficiary a limited power to withdraw the donated gift from the trust (usually 30 days). Most Crummey beneficiaries are so young that an adult (*e.g.* an uncle or aunt) is empowered to withdraw the funds on behalf of the beneficiary. Rarely are funds withdrawn, because if withdrawn, the donor will stop making future tax-free annual gifts to the trust. In comparison with other methods of making gifts to minors, the Crummey trust offers the most flexibility, making it possible to pool funds for the common use of all of the kids in a family and providing the best opportunity to avoid premature gifts to immature children. A Crummey trust can be a useful tool for offsetting the potentially huge income tax and estate tax hit on a taxpayer’s IRAs and pension plans. This is done by having the Crummey Trust acquire income tax and estate tax free life insurance with contributed funds derived from annual distributions from the donor’s pension plan or IRA.

### **529 college savings plans**

529 college savings plans allow single purpose gifts to be held for a person’s college education and are uniquely tax advantaged. These particular gifts can be made for the benefit of persons who are adults as well as children. Income accruing on these invested funds is not taxable (like a Roth IRA) and the donor can even retain some control over the investments and the future recipient. If the targeted donee does not later use the funds for college, the donor can substitute an alternate beneficiary! A special provision allows a donor to bunch upfront 5 years of tax excludable gifts in the first year! This allows a single donor to give up to \$55,000 in tax excludable gifts at one time (up to \$110,000 at one time, if a husband and a wife each contribute to the 529 plan). In addition, Montana allows a husband and a wife to separately claim an income tax deduction up to \$3,000 per year for contributions to 529 plans. If the funds are not used for college, income taxes will be imposed on the earnings and there will be penalties for withdrawals. There are other government education plans (*e.g.* Coverdell education savings accounts, allowing \$2,000 per year in contributions if the donor doesn’t make too much income), which offer additional ways of setting aside funds for a person’s education.

After reading this article, a person may want to consult with an attorney about the how to best make gifts to children and the related cost of developing a comprehensive estate plan. Relative to the benefits to be achieved, these costs may seem surprisingly worthwhile.