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William J. Bowe

TAX MOTIVATED GIFTS TO MINORS

BY WILLIAM J. BOWE

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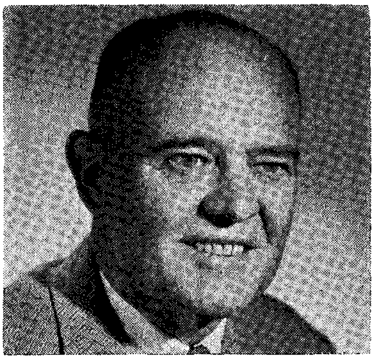

William J. Bowe: graduate of Fordham College and Harvard Law School; formerly in Judge Advocate General's Department; formerly professor of law, Vanderbilt University; presently professor of law, University of Colorado; author of **Tax Planning for Estates, Life Insurance and Estate Tax Planning, Income Tax Treatment of Life Insurance Proceeds.**

Prior to 1932 gifts to minors were primarily motivated by love and affection. As the title of this article indicates, many, if not most, gifts are today motivated by a very pronounced lack of any love or affection for the tax collector. These tax motivated gifts have their amusing aspects. In one family partnership case the agreement was drawn with the name of the new partner left blank —awaiting his momentarily expected birth so that name and sex could be inserted. Traditionally a nurse in the hospital is assigned to immediately announce the event to the male parent. In this case two nurses were delegated, the second to advise the impatient law clerk. *Redd v. Commissioner*[1] involved a partnership of husband, wife and four children, ages seven, five, two, and three months. The partner-wife testified on cross examination as follows:

Q. "Do you participate in the management of the business?"

A. "Well, I have been producing partners."

Q. "Beg your pardon?"

A. "I have been too busy producing partners so far."[2]

LIFETIME EXEMPTION AND MARITAL PRIVILEGES

In general gifts to infants do not present any problems different from those encountered in gifts to adults except for the difficulties that arise from the "present interest" requirement, if the annual gift tax exclusion is to be obtained. Gifts to infants are clearly chargeable against the $30,000 lifetime exemption. They qualify for the gift-splitting provision of the Code if the donor is

1 5 T.C.M. 528 (1946)
2 *Ibid.*

married and his spouse consents. If the infant donee is married and the donor is her spouse, the gift tax marital deduction is available. The peculiar problems arise with respect to the $3,000 annual exclusion and the present discussion will be largely limited to this aspect of gifts to minors.

Annual Exclusion

The exclusion is denied if the gift is one of a future interest in property. This means that to qualify the gift must be to a specific identifiable person who has an immediate right to possess and enjoy the property. It is not enough that the interest is immediately and indefeasibly vested. It must be presently usable. Thus a remainder interest will not qualify, even though it has a present value. It is not subject to immediate possession and enjoyment, in the required sense, though obviously it may be presently sold, mortgaged or disposed of by gift or will. There is the further requirement that the interest must be capable of valuation.

Outright Gifts

No difficulty has been encountered with respect to outright gifts, though it is difficult to understand how an infant of three can possess and enjoy a $1,000 bill, for example. But Rev. Rul. 54-400 states: "An unqualfiied and unrestricted gift to a minor, with or without the appointment of a guardian, is a gift of a present interest."[3] There are, however, practical objections to outright gifts to minors. United States savings bonds may be purchased for minors and they may redeem them. Cash may be kept in a *dry* trust in a savings account in the name of the parent for the minor. Beyond that, difficulties arise. Brokers are reluctant to deal in securities owned by minors. They are properly fearful of a successful suit if a stock is sold and subsequently rises in value. This is because of the minor's right to disaffirm. Titles are, to a large

[3] 1954-38 Int. Rev. Bull. 13.

extent, frozen. The minor's signature to a deed of real estate gives the buyer no assurance of permanent title. Of course, the appointment of a legal guardian will avoid these objections. But guardianship laws are more rigid than the powers that may be conferred upon a trustee. The guardian must generally post bond; he must account periodically to the court; in addition, the sureties on his bond will exercise a supervisory control. Generally, donors will be well advised to use the trust technique to obtain a reasonable degree of flexibility.

Gifts in Trust

A gift in trust, even if the life tenant or tenant for years is also the remainderman, is treated as partly a gift of a present and partly a gift of a future interest. Assume property is transferred to *A* for life, remainder to *B*, *A*'s interest, his life estate, is a present one. *B*'s interest, the remainder, is a future one. The value of the life estate will depend on *A*'s age, since it is measured by his life expectancy. Suppose *A* is fifteen, his present interest in a trust with a corpus of $10,000 is worth $7,600.

This rule, separating the gift into one of income and one of corpus, can lead to apparently absurd results. Suppose a trust is created to pay the income to *A*, age nineteen, for two years at which time the principal is to be distributed to him. Here the present interest, the right to the income for two years, has a value of $752. If he were to receive the income for fifteen years and then the corpus, the present interest would be worth $4,400. Obviously a gift with the right to the corpus in two years is worth much more to the donee than if he is to receive the corpus only after fifteen years, but the amount of the exclusion for the more valuable gift is very, very much less. The less valuable gift to *A* gets the full exclusion, the more valuable one, only 25% of the exclusion.

Discretionary Powers Over Corpus

Prior to the 1954 Code even more absurd results were reached. Assume a trust under which the income was to be paid to the minor for life with the sensible provision that the trustee might encroach upon principal in his discretion for the benefit of the minor. The cases denied the exclusion *in toto* because it was said to be impossible to value the present interest. The trustee might advance the entire principal to the infant the day after the creation of the trust. Hence no certain value could be attributed to the life estate. It would have no value at all, if the corpus were distributed the day after the gift. Of course everyone knew this wouldn't happen. But since no precise value could be given to the income interest, the full exclusion was forfeited. Happily Congress has overruled these cases by providing that the possibility that the life interest may be diminished shall be disregarded if the discretionary power can be exercised only in favor of the income beneficiary.[4]

[4] Int. Rev. Code of 1954, § 2503 (b).

DISCRETIONARY POWERS OVER INCOME

If the trustee is authorized to accumulate or distribute income, the gift of the income, apart from special statute to be referred to below, is a future interest since the minor has no immediate right to possession and enjoyment. He may enjoy only if the trustee decides to make a distribution. Meanwhile he has no present rights whatever. For the same reason, no exclusion is permitted for the typical sprinkle or spray type trust wherein the trustee is authorized, for example, to pay the income in whole or in part to either child *A* or child *B*. Here, again, neither child has any present right to anything.

POWER TO WITHDRAW CORPUS

To constitute a present interest, the donee's right must be absolute and immediate and the measure of the value of the interest is the value of that right. A mandatory direction to pay income to *A* will constitute a present interest in the income. For this reason, any trust of substantial amount for an infant will obtain the exclusion if the minor is given the right to the income for life or for any considerable number of years. But suppose the corpus is limited to $3,000 or $3,000 is added to an existing trust. Because either such gift is partly present and partly future, something less than the full exclusion will be allowed. To avoid this limitation draftsmen provided in many trusts that the infant should have the immediate and absolute right to withdraw the capital.[5] This privilege obviously gave the right to immediate possession and enjoyment of the entire principal. Some courts have recognized that this power gives the infant the equivalent of outright ownership. Other courts have taken the position that as a practical matter an infant of three years cannot make a demand and that if he did, the trustee would undoubtedly refuse to honor it. Of course, a guardian could make the demand for the infant. But what if no guardian had been appointed at the date of the creation of the trust? Is it a future interest because it will take time to effect the appointment? It seems absurd to make the result turn on the existence of a guardian, since in none of these cases is there any real likelihood that the power will ever be exercised during minority. At best, the case law is confused and uncertain.

[5] Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951).

The 1954 Code Provision

The 1954 Code makes it possible to obtain the exclusion by a gift in trust to an infant, if the donor is willing to meet the requirements of the statute. Section 2503 (c) provides that a gift to a minor shall not be considered a gift of a future interest if:

1. The income and principal may be expended by or on behalf of the beneficiary; and
2. To the extent not so expended will pass to him at the age of twenty-one, or if he dies prior to that time to his estate or to his appointees under a general power of appointment.

Under this statute, the trustee may accumulate the income in his discretion, but the entire fund (capital and accumulated income) *must* be distributed to the infant at age twenty-one. It is unfortunate to require that the capital be forced upon the infant at majority. This may be the worst thing that could happen to him. Normally, donors do not direct termination of trusts at twenty-one, particularly when the beneficiaries are so young at the time of the gift that no one can possibly foresee the kind of persons they will be at that age.

It is regrettable that Congress did not make the age thirty. Another objection to complying with the statutory requirements is that if the infant dies prematurely, the funds will pass in whole or in part to the parent, since by the law of most states, infants may not execute valid wills, at least until they attain an age very close to majority. Now, in many cases, one of the main reasons for these gifts to minors is to keep the funds out of the estates of the parents.

If, however, the client wants the exclusion, it is better to follow the statute rather than to make outright transfers or to rely on the existing case law. The outright gift will cause difficulties if it is later desired to deal with the property in any way, while the donee is still under age. The pre-1954 technique of giving the unlimited withdrawal power permits the naming of beneficiaries to take on the premature death of the infant and thus can effectively keep the property out of the estate of the parent. Further, the property is not forced into the lap of the child at age twenty-one, though it is his for the asking. Query: if either of these very nebulous advantages is worth the uncertainty? The donor using this method is in fact "buying" a law suit that may prove far more costly than foregoing many exclusions. Here is a typical clause that will satisfy the requirements of the statute:

> "The trustee shall have the sole discretion to distribute income to, apply for the benefit of or withhold income from, my grandson, George, as well as sole discretion to distribute corpus to, apply corpus for the benefit of, or withhold corpus from my grandson, George. Any income and corpus not previously distributed to or applied for the benefit of George shall be distributed to or applied for the benefit of George shall be distributed free of trust to him at age 21 or to his estate or to such person or persons including his estate or the creditors

of his estate, as he may appoint by his Last Will and Testament, in the event of his death during his minority."

THE STOCK EXCHANGE ACT

While the statute removes the tax uncertainty of gifts in trust, donors objecting to the expense involved in setting up small trusts sought a substitute that would avoid the trust expense but achieve the benefits of the management and investment characteristics of a trust. The New York Stock Exchange attempted to furnish the answer to this problem by a proposed model law concerning gifts of securities to infants. This law has been adopted in California, Colorado,[6] Connecticut, Georgia, New Jersey, North Carolina, Ohio and Wisconsin. It provides for registration of a stock certificate by a donor in his own name or in the name of any adult member of the minor's family "as custodian for ——————————, a minor" with delivery of the certificate to the custodian.

To qualify the gift for the exclusion the Act provides in Section 3 (a):

> The custodian shall hold, manage, invest and reinvest the property held by him as custodian, including any unexpended income therefrom, as hereinafter provided. He shall collect the income therefrom and apply so much or the whole thereof and so much or the whole of the other property held by him as custodian as he may deem advisable for the support, maintenance, education and general use and benefit of the minor, in such manner, at such time or times, and to such extent as the custodian in his absolute discretion may deem suitable and proper, without court order, without regard to the duty of any other person to support the minor and without regard to any other funds which may be applicable or available for the purpose. To the extent that property held by the custodian and the income thereof is not so expended, it shall be delivered or paid over to the minor upon the minor's attaining the age of twenty-one (21) years, and in the event that the minor dies before attaining the age of twenty-one (21) years it shall thereupon be delivered or paid over to the estate of the minor.

Many donors, adopting programs of small annual gifts, are using this device without appreciating the possible pitfalls that may be present. Nor are those taking advantage of it limited to residents of states in which the law has been enacted. A number of lawyers, representing mutual funds and companies whose stock is widely held for investment, have expressed the opinion that a resident of State *A* (which does not have the law) may make a gift to an infant, also a resident in State *A*, of stock in a company incorporated in State *B*, which does have the law, by sending the certificate to State *B* for transfer under the provisions of the Act. The basis of these opinions is that, under general conflict of law principles, the validity of a gift will be sustained if it is valid by the law of any state having a substantial connection with the transfer.

[6] Colo. Rev. Stat. Ann. § 125-5-1 to 12 (1955 Supp.).

DOES A TRANSFER UNDER THE ACT QUALIFY FOR THE EXCLUSION ?

The Internal Revenue Service has ruled, by letter ruling, that it does. But the Service has been known to reverse its position, particularly where the original analysis may prove faulty and when a reversal will result in increased revenue collections. Is such a gift, in view of the broad language of the Act, for the exclusive benefit of the infant or is it for the benefit of the parent *or* the infant in the discretion of the custodian?

Let us examine a transfer where the tax results seem clear. Grandfather transfers property to Son, as trustee, to use the income and principal, in his discretion, to pay the interest and principal of Son's mortgage or to pay income and principal to Grandson or to retain and accumulate them for later use for either of these purposes. I suppose all would agree that on Son's death any remaining capital will be part of his tax estate. He has a general power of appointment over the fund since at any time during his life he may freely appoint the property for his own benefit. Suppose the authority is to discharge his support obligation instead of paying off his mortgage. In the absence of specific statutory provisions, the income would be taxable to him, whether he used it for his benefit or not. This statement requires a word of explanation. In the *Stuart* case[7] the Supreme Court had held that where

[7] Helvering v. Stuart, 317 U.S. 154 (1942).

the grantor of a trust, as trustee, had the power to use the income for the support of his dependents the entire income was taxable to him, whether so used or not. Congress overruled this decision by limiting the amount taxable to him to the amount actually so used.[8] The 1954 Code now provides that where a person, other than the grantor, has the power to vest the income or principal in himself he shall be taxable on all the income except that, if this power is limited to use for support of dependents, only the amount so used shall be taxable.[9]

Now, assume a transfer from Father to Son, as custodian under the Act, for Grandson. May not the gift be held to be for the benefit of Son *or* Grandson, as Son decides. If so, he has a general power of appointment. Under the cases,[10] it is well settled that where Father creates a trust for Son but gives Mother an absolute power of withdrawal (in order to assure some parental control) that (1) the income will be taxed to Mother, (2) if she fails to exercise her power to withdraw and permits the income to be paid to Son, she will be treated as having made a gift of the income to Son, (3) on her death the remaining corpus will be part of her estate. These cases regard Mother as the real donee.

Would it be surprising to have the Internal Revenue Service reverse its letter ruling and hold that, in the assumed transfer from Father to Son, as custodian, that Son was the real donee? If the exclusion is for the Son, then there will only be one, even if there may be several grandchildren who were thought to be the donees.

Can these possible pitfalls be avoided if the custodian is one who has no legal obligation to support the infant? Then he would have only a special power and the income and estate tax problems suggested would vanish into thin air. But what of the exclusion problem? Suppose property is transferred to *X*, as trustee, to expend the income and principal for the payment of Son's mortgage or for distribution to Grandson or for accumulation for such later payment or use, as the trustee may determine. Here, Son and Grandson are discretionary beneficiaries. This is the typical sprinkle type trust. No exclusions are allowable here. None is allowable for Son since he may in fact never enjoy any part of the gift. The same is true as to Grandson.

If instead of discretionary authority to discharge Son's mortgage, the authority is to discharge his support obligation is he not equally a discretionary beneficiary, *if* the trustee's power is "without regard to the duty of any other person to support the minor and without regard to any other funds which may be applicable or available for the purpose"?

The objection to the Act is that it goes beyond anything required by the code section. It is certainly doubtful if, under trust law, a trustee, without express authority, may pay out income for the support of a minor without regard to the beneficiary's other

8 Int. Rev. Code of 1954, § 677 (b).
9 *Id.* § 678(c).
10 *E.g.,* Richardson v. Commissioner, 121 F. 2d 1 (2d Cir. 1941).

means of support.[11] The trustee must act in the best interests of his beneficiary, not in the best interests of the parent. Can it be in the best interests of the minor to use his own funds, if the parent has adequate funds for support?

Trusts Under the Code

The typical trust will avoid these objections by using the traditional language giving discretionary power to use income and capital and still come squarely within the language of the code section. The trust expense should not be a deterrent if a program of annual giving is planned, since the initial trust may serve as the vehicle to receive the gifts made in all the later years. Further, these trusts will grow to substantial size so that banks may be expected to welcome them even though they are initially small in amount.

Selection of Trustee

The donor should not be the trustee or one of the trustees. If he is, the corpus will be taxed as part of his estate because of the power to "alter, amend, revoke or terminate." In the *Lober* case,[12]

[11] Where a mother left property in trust for the support of her infant daughter until she should reach maturity, when the principal was to be paid to her, and after the mother's death the child was adopted, it was held that the trust fund should not be used to support her as long as the resources of the foster parents were sufficient for her support. In re Sylvester's Estate, 101 N.Y.S. 2d 804 (Surr. Ct. 1950).

[12] Lober v. United States, 346 U. S. 335 (1953).

the grantor-trustee had created an irrevocable trust for his children. The income was to be paid to the children until they reached a certain age at which time they were to receive the principal. The only retained power was one to advance principal to them from time to time in the discretion of the trustee. Since the grantor as trustee could accelerate the termination date, he was held to have retained power that came squarely within the section requiring the inclusion of the property in his estate.

SHORT TERM TRUSTS

It is not possible to qualify the short term trust for the 1954 Code's statutory exclusion for minors since these trusts contemplate the return of the capital to the donor at the end of the ten-year term. But short term trusts offer atractive opportunities for tax savings, without sacrificing the exclusion if the amount placed in the trust is at least $10,000 and the income is directed to be paid to the beneficiary. The transfer of $10,000 to a trust, income to be paid to *A* for ten years, corpus to revert to the grantor at the expiration of the period, will constitute a gift of the right to income for ten years. The value of such a right is equal to about 30% of the value of the prinicipal amount. In the case suggested, the value of the income interest is about $3,000.

Assume a married donor who is in a 60% income tax bracket. He has three children. Since he may use his spouse's exclusions, with her consent, he may create three trusts, one for each of the children, each in the amount of $20,000. Assuming the $60,000 produces 4%, he will lose gross income of $2,400 and net income, after taxes, of $960. Each child will have $800 of gross income, but an exemption of $600 and a standard deduction of $80. Thus, only $120 will be subject to tax. The combined taxes for the three children will amount to only *$72,* instead of *$1,440,* a saving over ten years of $13,368. Nor will the parent lose his exemption of $600 for each child if the children are under nineteen years of age.[13]

LONG TERM TRUSTS

Frequently, too much attention is paid to keeping within the

[13] Int. Rev. Code of 1954, § 151 (e).

exclusion. We have seen there are practical disadvantages to meeting the requirements of the 1954 Code. Further, the short term trust will be attractive only in a limited number of situations. Most donors will desire to remove the capital from their taxable estates, which the short term trust fails to do. Perhaps the most sensible approach is to create long term trusts that fall outside the statute and still obtain the exclusions by gifts of slightly more than the $3,000 or, in the cases of married persons, $6,000.

Assume our donor is married and that the prospective donee is age ten. A gift of $8,000 in trust requiring the trustee to pay the income to the infant for life, with power to encroach upon capital for his benefit, will constitute a gift of a present interest of $6,124. Thus the exclusions of the donor and his spouse will be obtained and, as they will split the gift, the amount of the excess, slightly under $2,000, will reduce the lifetime exemptions of each by less than $1,000. The gifts could be continued at the same rate for several years with the same results since the value of a life estate at such early ages diminishes each year at a negligible rate. This seems a far more sensible way of obtaining the exclusion than meeting the statutory requirements. But suppose the lifetime exemptions of the donor and his spouse have already been exhausted. Well, donors ought to be willing to pay something for the estate and income tax benefits that such gifts obtain. After all, one can't have everything free. Assume the donor is in a 30% estate tax bracket and a 60% income tax bracket. The gift of $8,000 will eliminate $2,400 of estate tax and the income it produces over the years will be taxed at 20% instead of 60%. This should be worth a few dollars of gift tax. Remember, only $2,000 of the $8,000 will incur tax and the beginning gift tax rates are not too high.

GIFT TAX RATES IN THE LOW BRACKETS[14]

Net Gift	*Tax*	*Rate on Excess*
$ 1,000	$ 22	2¼%
5,000	112	5¼%
10,000	375	8¼%
20,000	1200	10½%
30,000	2250	13½%

[14] Id. § 2502.