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TO: OUR CLIENTS AND FRIENDS

FROM: JACKSON M. PAYNE

DATE: OCTOBER 15, 2021

RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

SUZANNE PAULSON

It is with deepest regret that we write to let you, Suzanne's clients and friends, know that she died unexpectedly on September 9th.

Sorrow fills our hearts at this sad moment, a sorrow that is both deep and personal. She will be missed by all. Please keep her and her loved ones in your thoughts and prayers.

And, for those of you who have pending matters with Suzanne, please contact either Emily Ernst (205-986-5041) or Jim Wilson (205-986-5024). They will coordinate the handling of your matters in a timely fashion.

USING TRUSTS FOR TRANSFERS TO MINORS

The various advantages of using trusts, result in their frequent use for transfers to minors. In particular, Section 2503(c) discretionary trusts, Section 2503(b) income trusts, Crummey trusts, and incentive trusts are often established to facilitate gifts to minors. In this and following newsletters, I will review the pros and cons of each of these trusts. And I begin with the Section 2503(c) Discretionary or Minors Trust.

Section 2503(c) Discretionary (or Minor's) Trust

Generally, the annual exclusion does not apply to gifts of future interests in property. However, a special exception allows a donor to fully use his annual exclusion to transfer assets to a trust for the future benefit of a minor child. A transfer to an individual under age 21 will be treated as a present interest (qualifying for the annual exclusion) if the following conditions are met:

(a) The property and related income may be expended by or for the benefit of the minor before he or she turns 21; and

(b) Any remaining balance must be distributed to the donee when he or she reaches age 21, or be payable to the donee's estate (or subject to a general power of appointment) if he or she dies before reaching age 21.

A common use of Section 2503(c) trusts is to save for college expense, as an alternative to a Section 529 plan. Though they do not provide the same income tax benefits as a Section 529 plan, they provide more flexibly if the beneficiary does not need the funds for college expenses.

Because a minor cannot legally execute a will in most states, the trust property would pass back to the parents under the intestate statutes if the minor died. The parents could then disclaim the right to receive the trust property so that the property could go to siblings under the intestate statutes of the state. Alternatively, naming a contingent beneficiary would solve the problem of having to include the property in the parents' estates. However, to qualify the trust as a Section 2503(c) trust, the beneficiary must be given a general power to appoint the trust by will, and if that power is not exercised, the trust may then be distributed to contingent beneficiaries. The fact that the beneficiary is a minor and cannot make a will does not invalidate the general power.

The trustee of a Section 2503(c) trust must be given broad discretionary powers concerning distributions to the minor before age 21. There can be no substantial restrictions (e.g., limited to medical and educational expenses) in the trust instrument as to the nature and amount of these distributions. Similarly, the terms of the trust cannot require mandatory accumulation until age 21. Some potential donors consider this inflexibility to be a major drawback of the Section 2503(c) trust.

Some parents may prefer to use a combination of UGMA/UTMA account or a Section 2503(c) trust as a relatively small fund along with a larger, longer-term discretionary trust. However, with the compressed income tax rates for trusts, the large discretionary trust may have harsh income tax costs at the trust level, depending on the taxable or tax-exempt nature of the trust assets.

If the donor is the trustee of a Section 2503(c) trust, the discretionary power to control distributions (i.e., "beneficial enjoyment of the property") would cause the property to be included in his or her gross estate (if the donor/trustee dies before the trust terminates). In addition, the trust may be classified as a grantor trust for income tax purposes.

Some potential donors consider the ability of the donee to gain access to trust assets at age 21 a significant drawback to using Section 2503(c) trusts. However, in certain circumstances, the trust may continue in existence after the beneficiary turns 21. If the beneficiary has the power to extend the term of the trust, the exercise of that power will not cause the trust to fail to qualify under IRC Sec. 2503(c). The power may be a continuing right or a right for a limited period (e.g., 30 days after the 21st birthday) to compel distribution. If the right is not exercised, the trust continues to a later age, in accordance with the terms of the trust agreement. In any case, the donee must have the right to demand complete distribution at age 21.

The treatment of income earned by the trust is governed by the rules of Subchapter J- undistributed income generally is taxed at the trust level and distributed income is taxed to the beneficiary. The kiddie tax rules apply to distributed income if the beneficiary is either (a) under age 18, or (b) age 18 (or a full time student between the ages of 19-23) and his earned income is less than or equal to half of the amount of his support. If the donee has the power to demand complete distribution at age 21, but allows the trust to continue, IRC Sec. 678 causes subsequent income earned by the trust to be taxed to the donee.