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TO: OUR CLIENTS AND FRIENDS

FROM: JACKSON M. PAYNE

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RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

USING TRUSTS FOR TRANSFERS TO MINORS (CONTINUED)

Section 2503(b) Income Trust

A trust requiring all income to be distributed at least annually is sometimes referred to as Section 2503(b) or an income trust. Principal distributions can be made at some later date or at the occurrence of a certain event. The gift of the income interest, valued using IRS actuarial tables, is a present interest that qualifies for the annual exclusion (which is why this type of trust is also referred to as a Section 2503(b) trust). Note, however, a Section 2503(b) trust must be funded with income-producing property to be eligible for the annual exclusion.

The remainder interest is a future interest. If the trust is funded when the income beneficiary is young, the value of the remainder interest is usually (depending on the term of the trust) a relatively small portion of the total value of the transferred property. Therefore, most of the value of the assets transferred to the trust will be the income interest.

For income tax purposes, the donee is taxed on the trust income required to be distributed to the extent of the trust's distributable net income (DNI). The income will be taxed at their parent's marginal rate under the kiddie tax rules if the donee is under 18.

It may not be advisable to provide an income stream of cash to a minor or young adult. This may be a greater concern for parents than the kiddie tax problem. Alternatively, the income could be distributed to the custodian under UGMA or UTMA while the beneficiary is a minor.

An income trust should be considered when there is a concern that beneficiaries may exercise their Crummey withdrawal rights (discussed below) or when you do not want the burden of extra administrative duties associated with the Crummey power.

An income trust is not an appropriate choice if the trust is to be funded with nonproductive assets such as life insurance policies. Also, because a gift tax return is required every year a gift is made to the trust, a parent or other grantor who does not want this administrative burden may opt for a transfer alternative with fewer administrative requirements.

Crummey Trusts

The Crummey trust (named after a 1968 9th Circuit Court of Appeals case and subsequently accepted by the IRS in Rev. Rul. 73-405) satisfies the present interest requirement while allowing the donor to delay distributions of trust income and principal.

In the typical Crummey trust, the beneficiary is given the right to withdraw a specified amount of any contribution to the trust within a limited period of time. Amounts not withdrawn are added to trust principal.

The expectation of the donor is that the power to withdraw will not be exercised (although there should be no express or implied agreement to this effect).

Crummey trusts should be considered when there is a desire for multiple annual exclusion gifts or when the trust is funded with cash gifts (available briefly for withdrawal) subsequently used to purchase nonproductive assets such as life insurance policies.

The beneficiary's limited withdrawal right (a Crummey power) causes the gift to the trust to be a gift of a present interest that can be sheltered by the annual gift tax exclusion, which is indexed for inflation. The essence of a Crummey trust is that the existence of a present interest is determined by the presence of a legal right to withdraw, not the likelihood of its exercise.

In Ltr. Rul. 199912016, the IRS looked at four factors in determining if a beneficiary's withdrawal (Crummey) right qualified gifts to a trust as present interest gifts:

(a) The trust is required to give the beneficiary reasonable notice in which to exercise the withdrawal right.

(b) The beneficiary is given adequate time following notice in which to exercise the withdrawal right.

(c) When exercising the withdrawal right, the beneficiary will have the immediate and unrestricted right to an amount equal to the amount contributed to the trust.

(d) There is no understanding or agreement, expressed or implied, that the withdrawal will not be exercised.

We typically include a provision in the trust instrument requiring the trustee to give the beneficiary written notification of the transfer, and the beneficiary be given a reasonable period of time (e.g., 30 days) to exercise the power. Without this provision, the trustee should provide notice to the beneficiary as part of the trustee's fiduciary duties. For additional documentation, the trustee should seek a written acknowledgement from the beneficiary or the beneficiary's representative. Formalities should be observed even if the donee is a minor and the donor is a parent.

The IRS has been concerned about trust arrangements that give individuals Crummey withdrawal rights but no other economic interest in the income or principal of the trust (sometimes referred to as naked Crummey powers). The IRS takes the position that the beneficiaries of a Crummey trust must have an economic interest in the trust property for the present interest requirement to be satisfied. In other words, the beneficiaries should have a vested right to principal or income for the annual exclusion to apply.

The Tax Court, however, recently held that gifts to an irrevocable trust qualified for 60 gift tax annual exclusions because each of the trust's beneficiaries had Crummey withdrawal powers. The Court approved the annual exclusions even though the trust included a no-contest clause disinheriting a beneficiary who questioned a trustee's discretionary actions.

Until the power of withdrawal is exercised, released, or allowed to lapse, the person with the withdrawal power will be taxed on the trust income and capital gains attributable to that portion. In addition, a pro rata portion of the deductions and credits attributable to the amount for which the person has the withdrawal power will be attributable to that person.

When the income beneficiary and the remainder beneficiary are different individuals, a hidden gift tax trap awaits the Crummey power holder. When the power holder (i.e., the individual who has the power to withdraw the contribution for a limited period of time) allows the power to lapse at the end of the specified period, he has in effect made a transfer of a future interest in the property to the remainder beneficiary. If the power holder or his estate is also the remainder beneficiary, no transfer occurs because he would simply be making a transfer to himself. Where the power holder and the remainder beneficiary are different individuals, the lapse of the power may be a taxable gift to the remainder beneficiary under the power of appointment rules.

One planning strategy to eliminate potential gift tax when a Crummey power lapses is to limit the withdrawal power to a level that does not exceed the five and five limitation (e.g., a $5,000 gift). However, where the objective is to fully use the $15,000 (for 2021) annual exclusion (or $30,000 for split gifts where the spouse consents), the trust principal would have to equal at least $300,000 (or $600,000 in the case of split gifts).

Another solution is simply to make the Crummey power holder the sole beneficiary of the trust.

Alternatively, the power holder could be given a testamentary power of appointment over the property. These latter two alternatives solve the problem of the taxable gift caused by lapse of the withdrawal power but would cause the trust property to be included in the beneficiary's estate.

Because of the potential gift tax consequences of the lapse of the withdrawal power, we have advocated using a hanging Crummey power. In this situation, the lapse each year is limited to the "five and five" amount, even though the gifts exceed that amount. As a result, the withdrawal right remains open to the extent it exceeds $5,000/5%. The idea is that over a period of several years, the lapses would catch up with the cumulative gifts to the trust. However, it should be noted that the IRS rejected at least one version of the hanging power.

When grandchildren or other beneficiaries who are two or more generations below the donor (skip persons) and are designated as Crummey power holders, you should consider generation-skipping transfer (GST) tax implications. Generally, the GST tax annual exclusion will not apply to transfers to a Crummey trust because the annual exclusion does not apply to transfers in trust for GST tax purposes unless—

(a) distributions cannot be made to anyone other than the grandchild or other skip person during the grandchild's or other skip person's life; and

(b) if the grandchild or other skip person dies prior to the termination of the trust, the trust assets must be included in the grandchild's or other skip person's estate.

If those provisions are not met, the annual exclusion will not be available for GST tax purposes, and a portion of the donor's GST tax exemption will have to be used to shelter the transfer from the tax.

A person other than the grantor will be treated as the owner of any portion of a trust over which he has a power to vest trust income or principal in himself. Therefore, until a Crummey power is exercised or allowed to lapse, the power holder is treated as the owner of any income attributable to contributions made to the trust that are subject to the power. The income is reported directly to the power holder under the grantor trust reporting rules.

If the Crummey power holder (beneficiary) allows the withdrawal power to lapse but retains an interest in the trust property (which is usually the case), the beneficiary will continue to be treated as owner of that portion of the trust.

If the beneficiary is either (a) under 18 or (b) 18 (or a full-time student age 19-23) and his earned income is less than or equal to half of his support, the kiddie tax rules apply, which could cause the trust income to be taxed at their parent's marginal rates for unearned income in excess of $2,200 (for 2021). To minimize the income tax effects, the trustee could be authorized to invest in nonincome-producing property, such as growth stocks.