

# New Dimensions in Estate & Trust Planning

*An Article to Benefit Clients & Friends  
of*

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## GIFTS TO CHILDREN AND GRANDCHILDREN

### The Right Way

*by Richard L. Ferris, Esq.*

#### The Gift Giving Desire

In discussing wealth transfer planning with clients who have children or grandchildren, we hear parents (and grandparents) express very strong and definite ideas as to how their gifts during life are to benefit their child or grandchild. Parents/grandparents want to be sure the gift from them will be used for the "right" reasons, in the "right" way, by the "right" person, and at the "right" time. A successful, well thought out, gift-giving program to family members **can** achieve a parent's or grandparent's desires. Careful planning of GIFTS is a MUST, especially to minor beneficiaries since Virginia Law allows them to have access at age 18. Adult beneficiaries, likewise, may need protection of the gift from lawsuits, predators, immaturity or a failed marriage.

#### Reasons to Make Gifts to Family Members

Over the years of practicing estate planning law, clients have given the following as the major reasons for gifts to children and grandchildren:

(1) Gift, estate and income tax savings can be achieved since each donor (parent/grandparent) has a \$12,000 per donee annual exclusion (\$24,000 per couple). Gifts remove property from donor's taxable estate, creating an estate tax saving from 37%-55% on the gift and ALL future appreciation and income taxes on the gifted asset. In addition, gifts can achieve income tax savings since the donee (child/grandchildren) is often in a lower income tax bracket than the donor. The "kiddie tax" negates some of the income tax savings for donees under age 14.

(2) Gifting can provide support payments for family members for such items as private schooling, music, dance or sports lessons, college tuition, or start the donee on his or her own life insurance program.

(3) A Gift can provide a child with experience in handling money in a "supervised" way.

(4) Gifting to adult children can provide for the orderly transfer of the family business to succeeding generations.

(5) Starting a child/grandchild on his/her own Retirement Program has become a significant reason by clients for a gift-giving program.

### **Any Disadvantages to Gifts?**

There are a few reasons not to make gifts:

(1) There is no step-up in cost basis on the gifted asset. In other words, if the parent dies while owning the asset, the estate gets a stepped-up cost basis, thus eliminating the capital gain on the asset.

(2) **Outright** gifts to a "special needs" child may disqualify the child from obtaining government support benefits.

(3) By making gifts, the donor loses control of the property since the gift must be irrevocable and complete to obtain the tax benefits.

### **What Types of Assets Should Be Gifted?**

First, the economic and financial situation of both parent and child must be carefully considered prior to any gifting. In advising clients, we have a simple rule to follow: "Don't give away what you cannot afford to throw away."

The types of assets to gift depend on the objective of the plan. For example, if the parent/donor wants to provide income for the child, then a high-income yield asset should be transferred. If the donor seeks to shift post-transfer appreciation from the donor's taxable estate, then a high-growth asset should be transferred.

A transfer of stocks can provide the child with experience in handling investments. A gift of a life insurance

policy on the donor's life can produce significant estate tax savings at no gift tax cost or at a very low cost.

As a general rule, donors should consider transferring assets with a high-cost basis before transferring low-cost basis assets due to the attractive step-up cost basis equal to Fair Market Value on the asset occurring at death.

### **What Types of Transfers are Available?**

There are three ways to make a gift to a child or grandchild: (1) outright, (2) in custodianship for minors, or (3) in a Gifting Trust. Let's examine each of these ways, since each has its advantages and disadvantages.

#### **A. Outright Gift**

Although a donor's outright gift qualifies for the annual gift tax exclusion (\$12,000), and it removes the gift property from the estate, it is rarely used with minors due to the state guardianship requirements as well as the child's lack of maturity to handle property. For example, court appointed legal guardianship would be required for the management of the minor's property, involving cumbersome procedures, bonding, periodic accounting and unnecessary legal fees. Also, buyers, sellers, banks, or insurance companies will not deal with minors because of their legal right to void their contracts.

For adult beneficiaries, most parents and grandparents want to be sure the gift will be used for the "right" reasons, in the "right" way, and at the "right" time. Often, outright gifts get commingled with a spouse's funds, spent on unnecessary "things" and are subject to the child's creditors or a failed marriage. As a result, wise parents and grandparents who make gifts to their loved ones will avoid "outright" gifts.

#### **B. Gifts in Custodianship**

This method of making gifts to minor children is under the States' Statutory Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). UGMA

permits only transfer of cash, securities, insurance policies and annuities. UTMA allows the transfer of every type of property, real and personal. Gifts in custodianship (UGMA/ UTMA) are simple--"as custodian for"; no income tax filing requirement or custodianship is needed (minor reports the income); gifts qualify for the gift tax annual exclusion and removes property from the donor's estate unless the donor/parent is named a custodian. For smaller gifts (\$24,000 or less) to minors, **custodianship** is an acceptable method of gifting to minors. There are, however, significant disadvantages to this simple method of UGMA/UTMA gifting. There is a mandatory distribution requirement to the donee child at age 18 (unless age 21 is specified in the UTMA).

Generally, age 18 or 21 is much too early for children or grandchildren to take total control of the funds or property. Also, the early pay out will expose the gift to a child's spendthrift tendencies, predators, friends, creditors and spouse, if married. Moreover, at many colleges and post-secondary educational institutions, assets of the child in a UGMA/UTMA may count dollar for dollar against the child's qualification for student financial aid.

Though gifts in custodianship are preferable to outright gifts and do provide some degree of control and management, the use of trusts is usually advisable, especially with larger gifts to minors as well as ADULT children.

### **C. Gifts in Trust**

Of the three methods of making gifts to a child or grandchild, a **gift in trust** is the most flexible, manageable, appropriate and tax favored. Broad latitude and discretion can be allowed a trustee of your choice to pay over or withhold income and principal and meet changing circumstances before and after the child attains age 21.

We recommend to clients the use of a "sprinkle and spray" trust that qualifies for the gift tax annual exclusion (\$12,000). This type of trust is sometimes referred to as "The Irrevocable Gifting Trust." In such a trust, the donor provides the trustee (spouse, corporate fiduciary, CPA, or family member) the discretion to distribute income to the beneficiary(s) or let it accumulate in the Trust, as the trustee deems best. For income tax purposes, the trust income could be split between the trust and child or any number of beneficiaries, new children or grandchildren. This Irrevocable Gifting Trust can terminate when the child/beneficiary reaches an age of maturity (age 25, 30, 35) as selected by the donor/parent. In short, you, the donor, are in control of the gift; who receives it and how the gift is spent. This eliminates the MAJOR downsides to gifting—commingled gifts with spouses'; failed marriages; unwise spending on "things"; creditors, or unsuccessful business ventures.

The Irrevocable Gifting Trust can either distribute the income of the trust to the donor's children during their lifetimes or add the income to trust principal. The trust can also provide for the trustee's discretion to distribute the trust principal for the children's health, education, maintenance and support. Any remaining principal of the trust, upon the death of the children, becomes available for the grandchildren and other family descendants during their lifetime. Consequently, the trust principal skips Federal Estate Taxes at the children's generation and passes estate tax free to the grandchildren. This type of trust is called a "Generational Tax Skipping Gifting Trust." It is used with clients when they are making significant gifts to children and grandchildren for the purpose of long-term protection of their gifts from children's estate taxes and outsiders.

### **Summary**

If properly drafted and implemented, the "Irrevocable Gifting Trust" can achieve significant tax and non-tax benefits. It removes the property from the taxable estates of donor/parents and, at the same time, protects it

from any immature acts, potential divorce, creditors or predators of the children/beneficiaries.

**Gift**ing assets is based on a natural desire by parents and grandparents to see loved ones receive and enjoy wealth while they are still alive. It is critical, however, that these gifts be used for the "right" reasons, in the "right" way, and at the "right" time.

The "Irrevocable Gifting Trust" is a natural solution to the achievement of these goals. The essential characteristic of trusts is that they provide for the separation of ownership of an asset (in the trustee) and the beneficial enjoyment of that asset by the beneficiaries. As a result, all of the client's tax and non-tax goals are satisfied with the Irrevocable Gifting Trust!

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### *About the Author*

**RICHARD L. FERRIS** began his legal career in 1972 with the Ohio Attorney General's Office, Tax Section. After serving as a director of a major insurance company's Estate and Business Analysis Department, he founded Ferris & Associates in 1993, a Williamsburg, VA, law firm whose practice is limited to estate, trust, business continuation planning and after death administration.

Dick earned his B.S. Degree from the University of Dayton; Law Degree from Ohio Northern University; LL.M. (Masters of Law in Taxation) from Boston University; and his CLU (Chartered Life Underwriter), ChFC (Chartered Financial Consultant), and Masters of Science in Financial Services Degrees from the American College.

He has authored many articles on Estate Planning, including publication in the Virginia State Bar's *Trusts and Estates*. In addition, Dick is a frequent speaker before civic, social, and professional groups. He has co-authored three books on Estate and Trust Planning: **LEGACY—Plan, Protect and Preserve Your Estate**, **GENERATIONS—Planning Your Legacy and LOVE, MONEY, CONTROL—Reinventing Estate Planning**.

Dick is a member of the Virginia, Ohio, and District of Columbia Bars, as well as a member of the National Network of Estate Planning Attorneys. He is admitted to practice before the U.S. Tax Court.

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