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AUTHORS' NOTE

The Tax Reform Act of 1976, signed October 4, 1976, made sweeping changes in the existing federal estate and gift tax provisions of the Code. It repealed the specific exemption for gift tax, as well as the estate tax exemption.

Effective December 31, 1976, the federal estate and gift taxes were combined into a unified transfer tax under which lifetime transfers made after that date will be taxed cumulatively according to a new rate schedule, with the transfer at death being deemed the last transfer. Substantial credits against the unified transfer tax will be allowed in place of the repealed exemptions. The gift tax specific exemption referred to in the text continues in force, however, as to gifts made on or before December 31, 1976.

The annual exclusion with which this article deals remains intact and is unaffected by the provisions of the new Act.

I. Introduction

A gift to a minor, simple as it may seem, can become involved in a myriad of problems, some caused by personal and family considerations and others resulting from the provisions and technical requirements of the Federal Gift Tax Law. The purpose of this article is to point out and discuss certain of the salient issues relating to gifts to minors.

A. *Applicable Gift Tax Provisions*

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property, wherever situated, by gift by a citizen or resident of

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the United States, to the extent that it is not supported by an adequate and full consideration in money's worth and is not deductible or excludable. The tax applies whether the transfer is in trust or otherwise; whether the gift is direct or indirect; and whether the property is real or personal, tangible or intangible. It does not apply to the transfer by gift of intangible property after January 1, 1967, by a non-resident not a citizen of the United States, unless the donor is an expatriate who lost his U.S. citizenship after March 8, 1965, and within the ten year period ending with the date of transfer.[1]

Taxable gifts consist of the total amount of gifts made by the donor during the calendar quarter, reduced by applicable charitable and marital deductions and by the annual exclusion and that portion of the specific exemption utilized.[2] The gift tax applies only to transfers of property by gift by individuals, and is not applicable to transfers by corporations. The gift tax is payable on a quarterly basis beginning in 1971, and is imposed primarily on the donor.[3] If one spouse consents to gifts made by the other spouse to third persons, each becomes jointly and severally liable for the gift tax of both for that calendar year.[4]

A specific exemption of $30,000.00, allowed to each donor who is a United States citizen or resident, may be taken in its entirety in a single year or spread over a period of years. It is available for all types of gifts made, whether of present or future interests. In addition, a donor may annually exclude the first $3,000.00 of gifts of property, other than gifts of future interests, to each donee to whom he made gifts during that year.[5] There is no limit on the number of such donees, nor does the use of the annual exclusion affect the right of the donor to take advantage of the $30,000.00 specific exemption.

The annual exclusion and the specific exemption are completely independent of each other. The annual exclusion of $3,000.00 for each donee is not reduced in either amount or frequency by the use of the $30,000.00 specific exemption. Nor is the right to claim the $30,000.00 specific exemption affected if the donor has also claimed one or more annual exclusions.

A gift by one spouse to a third person may be considered as made one-half by each spouse, if at the time of the gift each spouse was a citizen or resident of the United States. This applies, however, only if both

1. Treas. Reg. § 25.2501-1(a), T.D. 7296, 1974-1 CUM. BULL. 255. For transfers by gift of real property and tangible personal property by a non-resident not a citizen of the United States, see Treas. Reg. § 25.2511-3, T.D. 7296, 1974-1 CUM. BULL. 255.

2. Treas. Reg. § 25.2503-1, T.D. 7238, 1973-1 CUM. BULL. 544.

3. Treas. Reg. § 25.2502-2, T.D. 7238, 1973-1 CUM. BULL. 544.

4. INT. REV. CODE OF 1954, § 2513(d).

5. The Gift Tax Law, as originally enacted in 1932, provided for an annual exclusion of $5,000.00 per donee, which was reduced to $4,000.00 in 1938, and to $3,000.00 in 1942. The reason for denying the exclusion for gifts of future interests is in the difficulty of determining the number of eventual donees and the values of their respective gifts. *See* H.R. REP. NO. 708, 72d Cong., 1st Sess. 29 (1931); S. REP. NO. 665, 72d Cong., 1st Sess. 41 (1931).

spouses signify their consent to treat all such gifts during that calendar quarter or calendar year as having been made one-half by each.[6] The effect of such consent is to increase the annual exclusion to each donee to $6,000.00 and to double the amount of the gift which can be made utilizing the spouses' combined specific exemptions. A pre-nuptial agreement under which each spouse waived all marital rights in the other's property will not prevent them from taking advantage of this provision of the Gift Tax Law in making gifts to third persons.[7]

B. Gifts of Future Interests

The annual exclusion is not available for a gift of a future interest, defined in the regulations as follows:

> (a) . . . 'Future interests' is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift.
>
> (b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. . . .[8]

If the donee does not have the present right of possession or enjoyment, even if the gift is vested under common law property concepts, the gift is of a "future interest" and the donor is not entitled to the annual exclusion.[9] If the gift is subject to an uncertain contingency, the gift is of a future interest, as when the joint action of two or more donees is required in order for the gift to be completed.[10] On the other hand, the presence of a spendthrift trust provision will not in itself turn a gift of a present right to receive trust income into a future interest.[11] Similarly, allowing the trustees to determine whether a beneficiary is incapacitated or to make payments at their sole discretion will not turn a present interest into a future interest.[12]

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6. Treas. Reg. § 25.2513-1, T.D. 7238, 1973-1 CUM. BULL. 544.
7. Rev. Rul. 55-241, 1955-1 CUM. BULL. 470.
8. Treas. Reg. § 25.2503-3, T.D. 7238, 1973-1 CUM. BULL. 544.
9. *Id.*
10. *See* S.P. Skouras v. Commissioner, 188 F.2d 831 (2d Cir. 1951); John M. Smyth, 2 CCH Tax Ct. Mem. 4 (1943).
11. Rev. Rul. 54-344, 1954-2 CUM. BULL. 319.
12. Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954).

Early litigation centered around the question whether a gift to a trust gave rise to only one annual exclusion, or an annual exclusion for each beneficiary of the trust. This controversy was resolved in Helvering v. Hutchings, 312 U.S. 393 (1941), which held that a donor could receive an annual exclusion for each trust beneficiary when he made a gift to a trust, except for gifts of "future interests." *See* Treas. Reg. § 25.2503-3, T.D. 7238, 1973-1 CUM. BULL. 554.

If the present interest requirements were taken literally, most gifts to minors would fail to qualify for the annual exclusion because of the legal incapacity of the minor to own and use the gift immediately. Recognizing this, the Internal Revenue Code has created certain formats through which gifts to minors would be eligible for the annual exclusion.

II. Types of Gifts to Minors

A. *Outright Gifts to Minors*

The greatest advantage of the outright gift is its simplicity. It will remove the property from the donor's gross estate for estate tax purposes, unless deemed a transfer in contemplation of death, and it will remove the income from the property from the gross income of the donor for income tax purposes. In addition, the donor will be able to utilize the $3,000.00 annual exclusion from the gift tax, as well as his $30,000.00 lifetime exemption. A gift to a guardian of a minor qualifies for the annual exclusion, as does a gift to a trustee for a minor, provided the trustee is required to use the property for the minor as if held by a guardian.[13]

The disadvantage of an outright gift to a minor is the inexperience and incapacity of the minor to manage, sell, invest or otherwise deal with the property. Requiring a guardian of the minor to manage the property is cumbersome and involves additional expense. If the outright gift is in liquid form, as a bank account, the minor may not be mature enough to handle the gift properly, and he may squander it for purposes unforeseen by the donor. The legal incapacity of a minor to make a will may well cause the property to return to the parents of the minor through intestacy should the donee die while still a minor. If the parents were also the donors of the gift, the tax purposes of the gift will have been thwarted.

An interesting distinction exists when an intended gift is made by the donor's transfer of property, such as bank accounts or U.S. Savings Bonds, into joint names with a minor. The gift is not completed merely by the creation of the joint tenancy in the property. There is a gift to the donee only when he draws upon the account, to the extent of the amount drawn, or when the donee cashes in the savings bond.[14]

B. *Custodial Gifts Under the Uniform Gifts to Minors Act*

The original purpose of this Act was to provide an easy way to make a gift of securities to minors. Therefore, the Act formerly limited the subject matter of the gift to securities, as there defined, and money.[15] The revised Act, however, broadened the gifts allowed to include life insurance policies and annuities.[16]

13. Rev. Rul. 54-400, 1954-2 CUM. BULL. 319; Rev. Rul. 59-78, 1959-1 CUM. BULL. 690.
14. Treas. Reg. § 25.2511-1(h)(4), T.D. 7296, 1974-1 CUM. BULL. 255.
15. 1 FED. EST. & GIFT TAX REP., ¶ 3145.08 at 4389.
16. *Id.* at 4394.

Gifts to minors under this Act eliminate the need for the costly and cumbersome court-supervised legal guardianship that may be required when an outright gift is made. Thus, one advantage of making custodial gifts under the Act is its simplicity. Gifts of registered securities may be effected simply by registering the securities in the name of the custodian. A gift of unregistered securities is made by delivery to a trust company or adult other than the donor, accompanied by a prescribed statement of the gift. A gift of money may be accomplished by transfer to a bank account in the name of the custodian, while a gift of life insurance is made by assigning the contract to the custodian.

Custodial gifts are simpler to manage than are outright gifts with guardianship, because no court accountings or inventories are required. Payments for "support, maintenance, education and benefit" of a minor are authorized without regard to the duty of the custodian to support the minor. The donor has the power to designate a successor custodian in the event of a vacancy. The custodianship terminates automatically at the age of majority. It is this requirement that makes resort to trusts created under section 2503(c) more acceptable when the gifts total up to substantial amounts and the donor desires to postpone distributions of principal until the donee is of more mature years. If the donee dies prematurely while still a minor, the property is in his estate. Thus custodial gifts, as well as outright gifts, may return by intestacy to the donor-parents.

Custodial gifts made under the Act will accomplish the donor's purpose of removing the property from his gross estate for estate tax purposes only if the donor is not himself the custodian or successor custodian. A donor-custodian will have the custodial property included in his gross estate under section 2038 of the Internal Revenue Code.[17] Gifts deemed to be in contemplation of death, moreover, will be included in the donor's gross estate.

Since the Uniform Gifts to Minors Act is designed to satisfy the requirements of section 2503(c), the $3,000.00 annual exclusion from the gift tax is available for custodial gifts.[18] The annual exclusion of this section is not lost in states that have amended their Uniform Act to require that custodial property be distributed at the age of eighteen, because the section states only the maximum restrictions which may be allowed on qualifying gifts.[19]

Custodial gifts will accomplish the desire of the donor to reduce his taxable estate, as well as his income tax burden, since income from the transferred property will be taxable to the minor donee. The one exception is that, to the extent the income from the gift property discharges the legal

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17. Rev. Rul. 59-357, 1959-2 CUM. BULL. 212; Rev. Rul. 70-348, 1970-2 CUM. BULL. 193.
18. Rev. Rul. 56-86, 1956-1 CUM. BULL. 449.
19. Rev. Rul. 73-287, 1973-2 CUM. BULL. 321.

obligation of support of a minor, the income is taxed to that person who has the obligation, whether that person is the donor or any other person.[20]

C. Gifts in Trust for Minors Under Section 2503(c)

Gifts in trust for minors that would otherwise be future interests qualify for the annual exclusion under section 2503(c) of the Internal Revenue Code if (1) the property and income may be expended by or for the benefit of the minor prior to his attaining twenty-one years of age; and (2) if not so expended, will pass to the donee upon his attaining majority; or in the event of his prior death, will be payable to his estate or as he may appoint under a general power of appointment. So long as the conditions of this section are complied with, the annual exclusions are available for gifts for minors. The fact that under local law a minor cannot execute a will or exercise a power of appointment will not affect the availability of the annual exclusion.[21]

Gifts made to trusts for minors that qualify under section 2503(c) have several advantages over custodial gifts under the Uniform Gifts to Minors Act. First, even in states that have reduced the age of majority to eighteen, a trust under section 2503(c) may delay receipt by the donee of the trust principal beyond the age of twenty-one years. So long as the donee at age twenty-one has the right to compel the immediate distribution of principal by means of written notice to the trustee, the trust will qualify under section 2503(c).[22] This is a reversal of the previous position taken by the Internal Revenue Service, that the trust had to automatically terminate at age twenty-one unless the donee requested in writing that it not terminate.[23]

Another advantage of the trust is in the distribution of principal should the minor die before the age of majority. Under the Uniform Gifts to Minors Act, if the minor dies, all property goes into his probate estate. This results in expensive estate administration, and the return of property to parent-donors by intestacy. A trust may be structured, however, to give the trust principal over to others if the minor dies without exercising his power of appointment or making a will. This in no way affects the right to an annual exclusion.[24]

Gifts in trust for minors also have an administrative advantage over custodial gifts under the Uniform Act. Some uniform acts limit the types of investments that may be made by custodians, such as excluding life insurance and annuities.[25] Trusts, on the other hand, may give the trustees broader investment powers. In addition, whereas the uniform acts usually limit custodians to adult members of the donee's family, or to a corporate trustee, trusts are not so limited in the designation of trustees.

20. Rev. Rul. 56-484, 1956-2 CUM. BULL. 23; Rev. Rul. 59-357, 1959-2 CUM. BULL. 212.
21. Treas. Reg. § 25.2503-4(b) (1958).
22. Rev. Rul. 74-43, 1974-1 CUM BULL. 285.
23. Rev. Rul. 59-144, 1959-1 CUM. BULL. 249; Rev. Rul. 60-218, 1960-1 CUM. BULL. 378.
24. *See* note 21 and accompanying text *supra*.
25. *See* note 17 and accompanying text *supra*.

Gifts to trusts for minors under section 2503(c) are not included in the gross estate of the grantor of the trust for estate tax purposes, unless the gifts are deemed to be in contemplation of death, or trust property is used to satisfy his support obligations. If the grantor of the trust is also the trustee, however, the trust principal could be included in his gross estate under sections 2036 and 2038. Only if a grantor-trustee's power to distribute principal is limited by a definite standard will it be excluded from his gross estate.[26]

For income tax purposes, the income from property given to the trust is taxable to the donee if distributable currently. If the grantor is also the trustee, he must avoid retaining a reversionary interest, a power to control the beneficial enjoyment of the trust, or the power to revoke the trust, which would invoke sections 673, 674 or 676 of the Internal Revenue Code, and thus impose tax liability on the grantor for trust income. If trust income is used to satisfy the support obligation of the grantor or any other person, that person would be subject to tax liability under sections 677(b) or 678(c). Should the income not be distributed to the minor currently, it is taxed to the trust until the time of distribution, when the impact of the throwback rules would apply. These rules carry back to years beginning after December 31, 1969, any distributions in excess of distributable net income for the year of distribution. The beneficiaries are taxed as if the income was distributed to them by the trust in the year in which it was accumulated, and receive credit for the proportionate part of the tax paid by the trust in the prior year.[27]

To qualify for the annual exclusion under section 2503(c) for gift tax purposes, all requirements of the section must be met. Although this section requires that property and income may be expended for the benefit of the minor prior to age twenty-one, restrictions limiting expenditure to the minor's general welfare, maintenance, support and education are permitted.[28] In addition, even though a minor may be incapable under local law to make a will or exercise a power of appointment, the present interest exclusion is not lost.[29] A trust may not, however, qualify for the present interest exclusion where the trust provisions are more restrictive than local law. For example in *Gall v. United States*[30] the trust instrument did not grant the minor beneficiaries a power of appointment until age nineteen. Yet the beneficiaries under state law could have married as early as age fourteen and thus been able to execute wills which would exercise their power of appointment. Therefore, these trusts did not qualify as present interests for the annual exclusion.

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26. Estate of Edward E. Ford, 53 T.C. 114 (1969), *aff'd*, 450 F.2d 878 (2d Cir. 1971); Estate of Ralph Budd, 49 T.C. 468 (1968).
27. *See* INT. REV. CODE OF 1954, §§ 665-69.
28. Treas. Reg. § 25.2503-4(b)(1) (1958); Rev. Rul. 67-270, 1967-2 CUM. BULL. 349.
29. *See* note 21 and accompanying text *supra*.
30. 521 F.2d 878 (5th Cir. 1975).

D. *Other Gifts in Trust for Minors Qualifying for the Annual Exclusion*

One of the disadvantages of a section 2503(c) trust is that at age twenty-one the beneficiary has the power to end the trust and receive the money outright. This power may be exercised at a time when the beneficiary has not matured and is incapable of handling the funds.

It is possible for a donor to create a trust for a minor, authorizing distributions at an age later than twenty-one, and still have the benefit of the gift tax annual exclusion. The mechanism to be utilized is a trust which will specify the ages at which the beneficiary is to receive the money. To accomplish this, the trust must contain a provision that the beneficiary has the right to withdraw during the year of the gift the sum of $6,000.00 ($3,000.00 if there is no spouse to split the gift) from the principal of the trust estate. In addition, this right may be made exercisable in succeeding years, limited to the total amount of principal additions made by the grantor in any such succeeding year, so that the annual exclusion will be available for such later gifts. Finally, a guardian should be appointed in the instrument to exercise such withdrawal while the beneficiary is a minor.

This method was approved in *Crummey v. Commissioner*[31] in which the trust instrument provided that a minor-beneficiary's guardian could demand annual payment of up to $4,000.00 from the trust. The court held that the annual exclusion was available for these gifts, even though it was unlikely that such a demand would ever be made, or that a guardian would be appointed. Since the demand could technically occur, however, the gifts were considered to be of present interests.

In this manner, trust principal may be kept for the benefit of a minor past the age of twenty-one and given to such beneficiary at a time when he or she has attained the maturity to handle such assets. At the same time, the donor can take advantage of the annual gift tax exclusion.

E. *Gift Must be Capable of Valuation*

The amount of a gift for gift tax purposes is considered to be its value at the time it is made. If the gift is of real or personal property, its value is based on its fair market value.[32] When one claims the $3,000.00 annual exclusion on that portion of the gift which is a present interest, one must establish that the interest is worth at least $3,000.00. The burden is on the donor to show qualification for the annual exclusion.[33]

A gift of stocks or securities traded on a recognized securities exchange is valued at the mean between the high and the low quotation on the date of the gift. On the other hand, the value of a gift of stock in a closely-held corporation is computed according to the formula set forth in

31. 397 F.2d 82 (9th Cir. 1968).
32. Treas. Reg. § 25.2512-1, T.D. 6826, 1965-2 CUM. BULL. 367.
33. *See* Stark v. United States, 477 F.2d 131 (8th Cir.), *cert. denied*, 414 U.S. 975 (1973).

the regulations. Similarly, a gift of an interest in a partnership is valued in accordance with the regulations.[34]

When, however, the gift is of an income interest in property, the amount of the gift is determined by use of the United States Treasury actuarial tables.[35] These are currently based on the assumption of a 6% annual return for the period of the gift, discounted to its present value on the date of the gift. The courts have held that these tables must be used in valuing such gifts.[36] There are certain exceptional situations in which the tables will not be insisted upon, as when irreversible medical conditions confirm the likelihood that an event will occur before the full period projected in the tables.[37] Another instance in which the tables will not be used is when a gift in trust of stock in a closely-held corporation is made for the benefit of a minor and the facts reveal that the corporation involved does not have the financial ability to pay dividends and has never declared a dividend, and that the trustee is restricted by the terms of the trust from disposing of the stock and reinvesting it in other income-producing property.[38] In such a case, the court stated that the actuarial tables

> are an appropriate means of fixing a value for gift tax purposes in cases where they may reasonably be expected to provide a fair approximation of the typical yield generated. But the tables are not appropriate in the case of a *non*-income-yielding instrument, for in such a case one can predict with assurance that the income generated will be *zero*, and, therefore, that the actuarial tables would produce an obviously erroneous result.[39]

Since the taxpayer failed to show that the income interests in question had any positive value, no annual exclusions were allowed.

F. *Gifts in Trust of Income and Principal to Same Minor Donee*

A trust may be divided into its separate components of income and principal in determining whether it qualifies for the annual exclusion. Even though the principal of the trust does not qualify, the income interest may qualify as a present interest under section 2503(c).[40] This is the doctrine of the *Herr*[41] case, which held that the term "property" in section 2503(c) does not necessarily mean the corpus of a trust. It may refer to the income interest only, which can be expended for the minor donee at the trustee's discretion or delivered to him upon attaining majority.

One question that remained after *Herr* was whether the portion of the income interest payable after the age of twenty-one would qualify for the

34. Treas. Reg. § 25.2512-2, T.D.7327, 1974-2 CUM. BULL. 294; Treas. Reg. § 25.2512-3 (1958).

35. Treas. Reg. § 25.2512-9 (1970).

36. McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953).

37. *See* Estate of Butler, 18 T.C. 914 (1953).

38. Berzon v. Commissioner, 534 F.2d 528 (2d Cir. 1976); Rev. Rul. 76-360, 1976-2 CUM. BULL. __ (1976).

39. 534 F.2d at 532.

40. Commissioner v. Herr, 303 F.2d 780 (3d Cir. 1962); Rev. Rul. 68-670, 1968-2 CUM. BULL. 413.

41. Commissioner v. Herr, 303 F.2d 780 (3d Cir. 1962).

present interest exclusion. In *Estate of Levine v. Commissioner*,[42] the donor created five irrevocable trusts for the benefit of his five minor grandchildren. Until each grandchild reached the age of twenty-one, the net income from the trust was to be accumulated. The trustees had the discretionary power to distribute the income or to expend it for each grandchild's benefit. Upon attaining the age of twenty-one, each beneficiary would receive the income accumulated up to that time, and would thereafter receive the income annually for life. The Tax Court decided that the entire income interest, both during minority and after the age of twenty-one, is treated as a single unit which qualifies as a present interest so long as the unrestricted right to income continues.[43] The Second Circuit, however, reversed the Tax Court and held that the income interest of a trust for a minor to be paid after attaining age twenty-one does not qualify as a present interest for the annual exclusion of the gift tax under sections 2503(b) and (c) of the Internal Revenue Code.[44]

G. *Gift of a Life Interest with Power in Trustee to Pay Trust Principal to Income Beneficiary*

The annual exclusion is available for a gift of the income interest of a trust, even though the trustee has the uncontrolled power to pay over the trust principal, in whole or in part, to the income beneficiary at any time. Although the life beneficiary's present right to receive income may thus be terminated or diminished, if no other person has the right to such income interest the gift will still qualify as a present interest for the purposes of the annual exclusion.[45] This rule was added to section 2503(b) to overrule a decision of the Third Circuit[46] that an income interest subject to diminishment by the exercise of such a power was not capable of being valued and was, therefore, a gift of a future interest for which the annual exclusion was not available. The rule of section 2503(b) does not apply, however, if the trustee can pay over any part of the trust principal to persons other than the life beneficiary while that beneficiary is still alive.

III. Conclusion

The material presented above reflects the intricate problems a donor may encounter in fulfilling his simple desire to make a modest gift to a minor donee and at the same time take advantage of the annual exclusion allowed for such gifts. The moral of the story is that our "tax life" has become so complex and fraught with pitfalls that even the most basic transaction with property requires the guidance of an expert. It is to be regretted that this is so!

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42. 526 F.2d 717 (2d Cir. 1975).
43. 63 T.C. 136 (1975).
44. 526 F.2d 717 (2d Cir. 1975).
45. INT. REV. CODE OF 1954, § 2503(b).
46. Evans v. Commissioner, 198 F.2d 435 (3d Cir. 1952).