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State and Federal Taxation: Gifts to or for Minors

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STATE AND FEDERAL TAXATION

Gifts To or For Minors

BYRON E. BRONSTON
Chicago, Ill.; Committee Chairman

I. WHY MAKE GIFTS TO OR FOR MINORS?

If a client has children, or grandchildren, who are the objects of his bounty, it is often wise to suggest that he regularly make gifts to or for them while they are still minors. In addition to the obvious income tax benefits presented when any income-producing gift is made from a high bracket donor to a lower bracket donee, there are gift tax benefits especially beneficial to minors.

The annual gift tax exclusion of $3,000 per donee ($6,000 if the donors are husband and wife) is lost if not used each year. Therefore, the sooner one takes advantage of it, the greater the total advantage taken. When one multiplies this by the number of children or grandchildren who might be donees, an important part that gifts made to or for minors can play in the overall estate plan is most apparent.

In maximizing the value of this practice of giving to minors, we do not intend to minimize the practical difficulties. It must be determined: whether the gift should be made outright or in trust; whether a guardian should be appointed or, if permitted by statute, a custodian should be named; whether the income tax consequences of the gift work more to the advantage or to the disadvantage of the donor, and of the donee; by whom the stocks should be voted, the checks cashed.

II. HOW PURPOSES FOR SUCH GIFTS MAY BE ACCOMPLISHED

A. Gifts Not In Trust

1. Gifts Outright

The Federal tax consequences of unqualified and unrestricted outright gifts to minors are now reasonably clear and predictable.

*Estate Tax.* Outright gifts effectively made more than three years prior to the death of the donor are by statute conclusively presumed to be not in contemplation of death and are thus removed from the donor's taxable estate. If the donor dies within three years subsequent to the gift, the transfer is presumed to be includible as a transfer in contemplation of death unless it can be shown that the gift was prompted by reasons other than those of death. The burden of proof is thrust upon the decedent's representative to substantiate motives associated with life rather than death.¹

*Income Tax.* Income-producing property that is effectively transferred to a minor-donee will remove the impact of income taxes from the donor. A parent may continue to take the $600 exemption for a child regardless of the child's income if the parent furnishes more than one-half of the child's support and the child is either under nineteen or a full-time student.² Income tax savings will usually follow transfer to a minor as a result of the minor's exempt status or lower tax bracket. In the event of subsequent sale of the transferred property by the donee the basis for purposes of gain remains that of the donor; for purposes of loss, however, it is the donor's basis or the fair market value of the property at the date of the gift, whichever is lower.³

*Gift Tax.* Outright gifts of present interests of not more than $3,000 each can be given by a donor to any number of donees without impact of gift tax or requirement of filing a gift tax return. Of course, it will be considered advantageous in some cases to increase gifts to amounts in excess of $3,000 deliberately to require filing a return in order to start the statute of limitations running. The entire amount of any gift of a future interest is reportable. The gift splitting provisions available to husband and wife are applicable only when the donor's spouse signifies consent to treat the gift as having been made one-half by each, in accordance with Treasury Regulations.⁴

2. Gifts with Conditions, Restrictions or Limitations Attached

The reservation or attachment of conditions, restrictions or limitations on gifts to minors can completely alter the tax consequences.

*Estate Tax.* If the donor reserves a life estate in the property transferred or the right, alone or in conjunction with any person, to designate who shall enjoy the property or its income, then on death of the donor the value of the property is includible in the donor's taxable estate.⁵

If the possession or enjoyment of the property transferred can be obtained only by surviving the donor, and the donor has a reversionary interest in the property, then on death of the donor the value of the property so transferred is included in the donor's taxable estate provided the reversionary interest had a value in excess of 5% of the entire property immediately before the death of the donor.⁶

If the donor reserves the power, either alone or in conjunction with any other person, to alter or change the enjoyment of the transferred property, such property is, on death of the donor, included in the donor's taxable estate.⁷

*Income Tax.* Even though income from property is normally attributable to the owner, family transactions are subject to close scrutiny and all the circumstances are to be considered in determining whether a purported gift is bona fide.⁸

*Gift Tax.* Even though a gift may be wholly "outright" from the viewpoint of state substantive law, it may be considered sufficiently limited or restricted by gift tax standards to make the gift a "future interest" and thus not eligible for the $3,000 annual exclusion.⁹

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³Sec. 2036.
⁴Sec. 2037.
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lar interpretation of estate, gift and income tax law.

3. Present or Future Interests.

Prior to 1954 there was uncertainty as to whether an outright gift to a minor could qualify as a present interest for annual exclusion in view of a minor's disability to act except through a legal guardian. This uncertainty has been resolved by Revenue Ruling 54-400 which provides that "An unqualified and unrestricted gift to a minor with or without the appointment of a legal guardian, is a gift of a present interest..." 21

4. Practical Considerations in Outright Gifts.

Despite the considerable tax advantages of gifts to minors, no program should be instituted or continued without sober consideration to:

(1) the possibility that sale or management of property standing in the name of a minor cannot take place so as to freeze its use;

(2) the possibility that the donated property may be dissipated by an irresponsible or emotionally charged youngster (or the youngster's spouse) and forever removed from the control of the family;

(3) the possibility that possession and control over property may extend to a minor a measure of financial independence that proves debilitating; and

(4) the dangerous liabilities that may attach to any person, however innocent, who transacts business with respect to property of a minor who can disaffirm. 12

For annotated discussion of practical and tax problems incident to outright gifts of currency, checks, deposits, tangible personal property see Fleming, Gifts for the Benefit of Minors; 13 and Rogers, Some Practical Considerations in Gifts to Minors. 14 For general discussion of outright (and other) gifts to minors see, in addition to articles previously mentioned, Beck, "How to Make Effective Gifts to Minors," 15 and Caplin, "How to Treat Gifts to Minors." 16

5. Gifts of Stock to Minors.

Revenue Rulings since the adoption of the 1954 Code have done a great deal to clarify that which was formerly obscure. Revenue Ruling 54-400, as previously mentioned, held that an unqualified and unrestricted gift to a minor with or without the appointment of a legal guardian, is a gift of a present interest, without regard to disabilities placed upon minors by state statutes. According to this Revenue Ruling, also, it is only where delivery of the property to the guardian is accompanied by limitations upon the present use and enjoyment that the question of a future interest arises.

On January 6, 1956, a Special Ruling was issued by the Division concerning the application of the future interest rule to the outright gift made to a minor in accordance with the Colorado statute adopted in 1955. 17 The Director's conclusion was the gift was completed for gift tax purposes on the date the shares were registered on the books of the corporation in the name of the donor as custodian for his minor daughter. This transfer of shares represented a gift of a present interest in property within the meaning of Section 2503(c) of the 1954 Code.

Subsequently, Revenue Ruling 56-86, I.R.B., 1956-11, page 11, followed almost exactly the Special Ruling of January 6, 1956. However, it contains no reference to the application of Federal estate tax to the donor's estate, but also recites that the income tax consequences are still under consideration by the Service. 18

The Special and Revenue Rulings also settle the question of delivery. The gift is effective "on the date the shares were registered on the book of the corporation in the name of the donor as custodian".

It can be safely stated that the ambiguity created by the non-trust cases, prior to the adoption of the Internal Revenue Code of 1954, is now ancient history.

The taxpayer must observe literally the language of Section 2503(c) of the Internal Revenue Code of 1954 in order to obtain his exclusion. Where the gift is to a custodian, such as under The Gifts of Securities to Minors Act, the manner in which the income will be taxed may conceivably be subject to the application of Sections 674(b), 677(b) (if used to discharge an obligation of support), or 678(c) if the custodian is one who falls within the definition of a "related or subordinate party." There are some who feel that the statutes au.

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12 Gifts to minors considered "future interest": Fleming, Gifts for the Benefit of Minors, 49 Mich. L. Rev. 829 (1951); Fleming, A Different View of Outright Gifts to Minors, 7 Tax L. Rev. 89 (1951). Gifts to minors considered "present interest": Rogers, Outright Gifts to Minors and the Gift Tax Exclusion, 7 Tax L. Rev. 84 (1951); Rogers, Some Practical Considerations in Gifts to Minors, 20 Ford L. Rev. 283 (1951).


15 Supra, note 10.

16 Supra, note 10.


19 The new custodian statutes have now been adopted by 14 states as follows: Cal., Colo., Conn., D. C., Ga., Mich., N. J., N. Y., N. C., Ohio, R. L., S. C., Va., and Wis.

20 A special ruling was issued March 27, 1956, holding the income taxable to the parent to the extent it is used for the minor's support, irrespective of who the donor is. See Widmark, Security Gifts to Minors, Aug. 1956 Trusts and Estates 698.—Ed. Note.)
torizing the transfer of securities to a custodian may have created thereby a "trust by statute" with both income and estate tax problems following therefrom while satisfying a desirable gift tax objective. Where the gift is outright to the minor or to his guardian, the transfer will not be treated as a portion of the donor's taxable estate as long as the gift was not made in contemplation of death. But a gift in trust presents other problems.19


It took a combination of calculated revisions in the 1954 Code to render it possible to make a gift of a life insurance policy to a minor under such conditions that the gift would constitute a gift of a present interest for the purpose of determining the gift tax exclusion authorized by Section 2503(b). First Section 2042 of the 1954 Code removed the old "premium payment test." Section 2503(c) makes no distinction as to the type of "property" that may be transferred to a minor if such transfer qualifies under the limitations in that section. It is now permissible to transfer a life insurance policy to a minor for the gift tax exclusion. Revenue Ruling 55-408 I.R.B., 1955-56, page 32, further clarifies the problem. It states:

"Under the regulations a gift of an insurance policy having no cash value is not a gift of a future interest merely because the policy has no cash value. However, a gift of an insurance policy, whether or not it has a cash value, may or may not be a gift of a future interest, depending upon whether, by the terms of the gift, the interests of the donee in the policy are in some manner restricted. Accordingly, it is held that where a policy of insurance, which grants to the owner the usual incidents of ownership, includ-

ing the right to change the beneficiary and the right to surrender the policy for its cash value, if any, is transferred or assigned to a donee as absolute owner, and the donee, or his guardian, is not restricted in any manner from exercising all legal incidents of ownership in the policy, by prior endorsement or otherwise, a gift of the policy and subsequent payment of premiums thereon by the donor will constitute gifts of present interests for the purpose of determining the gift tax exclusion authorized by Section 2503(b) of the Internal Revenue Code of 1954."

There appears to be only one point of possible conflict between this Revenue Ruling and 54-400 cited above. In the latter, it is stated that an unqualified and unrestricted gift to a minor, "with or without the appointment of a legal guardian," is a gift of a present interest, whereas Revenue Ruling 55-408, above cited, contains the language "... and the donee, or his guardian ..." Would this mean that where the outright gift to a minor is one of a life insurance policy, a guardian is absolutely necessary? It appears that the logical interpretation of the two Revenue Rulings read together would produce a negative answer.

The points of caution concerning outright gifts of life insurance policies to minors are twofold. The first is the statutory language concerning the application of the 3% reversionary interest rule in Section 2042(2).

The second is the application of the rules established by the cases prior to the 1954 Code. Many of these rules will remain in effect. As pointed out in Revenue Ruling 55-408 the Nashville Trust case cannot be considered as authority for holding that a gift of an insurance policy is a gift of a future interest unless it has cash value. In fact, the Commissioner has ascribed as the rule of that case that the gifts involved were gifts of a future interest by reason of the terms of the settlement options exercised by the donor prior to the assignment. It appears that the donee would not have access to accrued surplus for a period of two years from the date of the assignment. Ostensibly, therefore, a lack of access to accrued surplus would still result in a determination of future interest and consequent loss of the annual exclusion.

Similarly, where the rights of the donees cannot be exercised by one without the consent of others necessitates a holding that the interest is future.21 Similarly, where joint action will be necessary for a severance of joint assignments,26 or where the donee is not given a present right and therefore could not surrender the policy for cash and could not borrow upon it, then the gifts will be of future interests.23

If the donor has made the gift within the three-year period prior to his death, the question of a gift "in contemplation of death" will still arise.

The valuation of transferred life insurance policies by way of gift to minors will probably be clarified by the regulations. Presumably there will still be distinctions made in valuation methods applied to single premium and paid-up policies, and to annual premium policies.24

7. To Use or Not to Use a Guardian.

A recent Internal Revenue Ruling has conclusively answered the question raised by the Stifel case by holding that an unqualified and unrestricted gift to a minor, with or without the appointment of a legal guardian, is a gift of a present interest and therefore qualifies for the annual gift tax exclusion.

Guardians in the majority of states are limited as to investments they can make by a legal list or by the requirement of a prior court order authorizing the investment. In other jurisdictions, a guardian is subject only to the reasonable and prudent-man rule, while at least in one state there are no restrictions on investments by guardians.

Gifts of property may be retained by the guardian in some jurisdictions regardless of the type of property, while in others retention by the guardian is subject to the reasonable and prudent-man rule.
rule, a legal list or to court order. Restrictions of this nature, although imposed for the purpose of protecting the minor’s interest, quite often limit the use of the gift beyond the wishes of the donor. If the use of a guardian is contemplated, the donor should thoroughly understand the restrictions and limitations imposed in his jurisdiction.

The Association of Stock Exchange Firms has adopted a model “Gifts of Securities to Minors Act,” designed to simplify the procedures which might otherwise cause the donor to refrain from making such a gift merely because they are so involved.\(^2\)

A recent ruling\(^3\) has held that a transfer of securities to a minor donee pursuant to this statute constitutes a completed gift for Federal gift tax purposes at the time the transfer was made, and that such gifts come within the purview of Section 2503(c) of the 1954 Code, therefore qualifying for the annual gift tax exclusion.

In summary, the qualification for gift tax exclusion of an outright gift to a minor is not affected by the presence or absence of a guardian. Where the gift is of securities, in those jurisdictions which have adopted the Gifts of Securities to Minors Act, a guardian need not be used. The donor must decide between (a) an outright gift to the minor directly, accompanied by the complete lack of control over the gift; (b) an outright gift to a minor through a guardian, together with statutory restrictions and limitations imposed on investments and retentions by guardians in most jurisdictions; (c) a gift by the use of an inter vivos trust; or (d) in those states which have adopted the Gifts of Securities to Minors Act, a gift to a custodian.

B. Gifts In Trust

1. Present or Future Interests.

In deciding whether to make the gift outright to the minor or in trust for him, the donor must consider the tax concept of present versus future interests. The outright gift can easily be made so as to utilize the annual exclusion of $3,000 for gifts made to each donee.\(^4\) A gift in trust may or may not be a “present interest” gift for which this exclusion would be available.

However, the tax consideration must be secondary. First, the purpose of the gift, other than tax savings, must be examined. Is the gift made primarily to save income taxes? To teach the minor how to handle money and invest wisely? To create a separate estate for the minor to receive at age twenty-one? To circumvent risks of business losses? To protect the beneficiary beyond age twenty-one, as in the case of a handicapped child?

If the intent is for the child to receive the property at age twenty-one, the new Section 2503(c) of the Code provides a perfect, yet simple, method of accomplishing the donor’s objective while using a trust arrangement. At the same time the donor would receive the benefit of the annual exclusion. This section states that no part of the gift is a future interest if both the property and the income (1) may be expended by, or for the benefit of, the donee before his attaining the age of twenty-one years, and (2) will, to the extent not so expended, pass to the donee at age twenty-one or his estate or as he may appoint under a general power of appointment if he dies before reaching twenty-one.\(^5\) The power of appointment provision may have some value but it raises questions of state law: Can a minor effectively exercise such a power during minority and is the trustee protected in relying on such exercise? Can a minor make a will?

The main tax disadvantage in using the arrangement under Section 2503(c) is that if the minor dies before age twenty-one, the property is subject to death taxes. However, this same factor is true of gifts outright to a minor.

Under this new section there is a distinct income tax advantage. The trust is a taxpayer as well as the minor beneficiary. Thus by distributing a portion of the income and accumulating the rest, on which part the trustee pays the income tax, lower bracket tax savings may be effected. But Section 677(b) and 678(c), discussed later herein, should be considered before income is used for support and maintenance of the beneficiary. The accumulated income which is distributed at age twenty-one is, of course, not subject to the “carryback” rules applicable to excess distributions.\(^6\)

If the grantor wants the trust to extend beyond age twenty-one, he runs right into the future interest problem. Where the primary purpose of the trust is protection of a handicapped child throughout the child’s lifetime, the grantor should forget about obtaining the annual exclusion and either use his lifetime exemption or pay the gift tax. He may still obtain income tax benefit over the years and estate tax benefit at his death.

However, for other minors the grantor may obtain tax benefits under the gift tax law as well. A trust for a minor child with the trustee, with powers of a guardian, having discretion to pay the income and the principal\(^7\) to go for the benefit of the child until the child attains the age of thirty-five, with the minor child himself (without any other approval) or his guardian having the absolute right to demand payment to him of the income, accumulated income, and principal, or any part thereof, and with the unexpended income and principal passing on death of the beneficiary to the beneficiary’s estate or as appointed by him under a general power of appointment should qualify for the annual exclusion. The trustee should be absolved of any liability for payments made on the demand of the beneficiary while a minor. However, such a trust might involve a lawsuit to uphold the annual exclusion.

This arrangement would overcome the objections of Ryerson \textit{v. United States},\(^8\) United States \textit{v. Pelzer},\(^9\) Stifel \textit{v. Comm.},\(^10\) Evans \textit{v. Comm.},\(^11\) and other cases. But the only way to assure the proper use of the annual exclusion is to follow Section 2503(c) and terminate at age twenty-one.

2. Discretionary Powers in Trustee.

The problem to watch is the giving of

\(\text{\footnotesize{See Senate Committee Report (83d Cong. 2d Comm., note 26).}}\)

\(\text{\footnotesize{Rev. Rul. 56-86. I.R.B. 1956-11, p. 11.}}\)

\(\text{\footnotesize{See report herein of Committee to Cooperate with National Conference of Commissioners on Uniform State Laws.}}\)

\(\text{\footnotesize{Rev. Rul. 66-86, I.B. 1966-11, p. 11.}}\)

\(\text{\footnotesize{Sec. 2503(b). The exclusion may be $6,000 if the conditions of Sec. 2513 relative to a spouse’s consent are fulfilled.}}\)

\(\text{\footnotesize{See supra, note 26.}}\)

\(\text{\footnotesize{196 F. 2d 435 (1952).}}\)
more than ten years after the date of transfer (two years is period in case of certain charitable trusts), or if the trust is to last until the death of the income beneficiary, even though such beneficiary does not have a life expectancy of ten years. This new statutory rule appears to be fairly precise and easy to follow; and the committee reports and the proposed new regulations largely paraphrase the wording of the Code.

For taxpayers in high income tax brackets, this rule, with certain related sections of the new Code, provides an opportunity to create short term educational trusts for minor children. which can qualify for three separate tax objectives and still fit in fairly well with the reasonable desires of the average grantor:

(a) The income can be made attributable to the minor child for federal income tax purposes;
(b) There will be the so-called “double exemption” with respect to each minor child, i.e., each child will be entitled to a $600 income tax exemption on his or her income tax return, and in addition, the grantor-parent will, with one minor exception, be entitled to a $600 dependency exemption for each child;
(c) The value of each child’s income interest can be made to qualify for the $3,000 gift tax exclusion ($6,000 if the grantor is married).

In the case of the well-to-do father with minor children who are approaching college age, the income tax advantages of this kind of arrangement are obvious, and they can be attained without undue sacrifice of the dispositive desire of the parents. Qualifying the income interests for the gift tax exclusion is not quite so easy. Each of the three tax objectives mentioned above will be discussed in order, from the point of view of the necessary precautious provisions which must be included in the trust instrument.

Under Section 673 itself, the grantor, in order to avoid having the income attributed to him, must provide that there shall be no reversion until the expiration of ten years or the death of the particular child, whichever event shall first occur. The foresighted grantor, therefore, who wants his property back following the completion of his child’s education, should establish such trust several years prior to the time that his child expects to enter college, so that the reversion will not be postponed materially beyond the time when the child has graduated. However, the parent may well wish to postpone the reversion until three or four years after the child’s graduation from college so as to provide for the possibility of graduate school or the needs of a child during the first few years after he has started to work. The trustee, or at least one-half of the trustees where there are more than one, should not be related or subordinate parties, to avoid the application of the provisions of Section 674 relating to various types of fiduciary powers to control beneficial enjoyment.

Great care must be given to avoid the provisions of Section 677 relating to income which is deemed to be for the benefit of the grantor. Parents are universally required by law to support and maintain their minor children. If the income from the trust is used for this purpose, it will be attributable to the parent-grantor. This poses a number of problems, the solution of which is at least partially dependent on the State law of the particular jurisdiction; and the line of demarcation between what expenses are or are not the parents’ legal obligation is a hazy one. Certainly the application of the trust income to help pay the family grocery bills and the upkeep of the home, even though it is an expensive home, would jeopardize the trust from an income tax point of view. On the other hand, the application of the income for college tuition or the expenses of a trip to Europe are not expenditures of the type which a father is legally obligated to provide. It is certainly arguable that the tuition fees of a preparatory school are not legal obligations in states which require compulsory education for twelve years, since free public schools are so universally available. Quaere as to the expense of board and lodging while a child is away at school or college.

The simplest way to handle this matter would seem to be to provide that the trustee shall pay to or expend on behalf of the child the income of the trust estate for the child’s advancement, college education and graduate school education, and to specifically direct that no portion of such net income shall be paid or expended for the maintenance or support of the child which the grantor is legally obligated to provide for. If the trustees guess wrong and pay an item which is a legal obligation, no great harm will occur, for under Section 677 only the income used to pay that item will be attributed to the grantor. In connection with the applicability of Section 677, it should be kept in mind that if capital gains are incurred in the trust, the income of the trust will be attributable to the grantor unless the gains are to be treated as income.

With respect to the so-called “double exemption”, it should be kept in mind that under Section 151 (e) the grantor will lose his dependency exemption for any minor child who is over nineteen years of age and has more than $600 of income if the child is not a student, but

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Discretionary powers to a trustee without an accompanying “present right” of the minor to demand all the income and principal. It must be clear that upon demand by the beneficiary there is no discretion in the trustee to withhold.

The trustee should have no power to change the shares. The trusts for children should be separate trusts, with no benefit being available for any person other than the one beneficiary of that trust. Otherwise, the interest is incapable of valuation.

Gifts in trust of particular kinds of property may raise future interest questions also. Most of the decisions involving insurance trusts have involved considerations other than the inherent nature of the proceeds. If there are other investments in the trust, Section 677(a) (3) of the Code should be thoroughly studied, for otherwise income could be taxed to the grantor.

3. Use of Short Term Trusts.

Section 673 of the Code provides that a reversionary interest in the grantor will not cause the income of the trust to be taxed to him if the reversion may reasonably be expected to take effect within ten years after the date of transfer (two years is period in case of certain charitable trusts), or if the trust is to last until the death of the income beneficiary, even though such beneficiary does not have a life expectancy of ten years. This new statutory rule appears to be fairly precise and easy to follow; and the committee reports and the proposed new regulations largely paraphrase the wording of the Code.

For taxpayers in high income tax brackets, this rule, with certain related sections of the new Code, provides an opportunity to create short term educational trusts for minor children which can qualify for three separate tax objectives and still fit in fairly well with the reasonable desires of the average grantor:

(a) The income can be made attributable to the minor child for federal income tax purposes;
(b) There will be the so-called “double exemption” with respect to each minor child, i.e., each child will be entitled to a $600 income tax exemption on his or her income tax return, and in addition, the grantor-parent will, with one minor exception, be entitled to a $600 dependency exemption for each child;
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Great care must be given to avoid the provisions of Section 677 relating to income which is deemed to be for the benefit of the grantor. Parents are universally required by law to support and maintain their minor children. If the income from the trust is used for this purpose, it will be attributable to the parent-grantor. This poses a number of problems, the solution of which is at least partially dependent on the State law of the particular jurisdiction; and the line of demarcation between what expenses are or are not the parents’ legal obligation is a hazy one. Certainly the application of the trust income to help pay the family grocery bills and the upkeep of the home, even though it is an expensive home, would jeopardize the trust from an income tax point of view. On the other hand, the application of the income for college tuition or the expenses of a trip to Europe are not expenditures of the type which a father is legally obligated to provide. It is certainly arguable that the tuition fees of a preparatory school are not legal obligations in states which require compulsory education for twelve years, since free public schools are so universally available. Quaere as to the expense of board and lodging while a child is away at school or college.

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With respect to the so-called “double exemption”, it should be kept in mind that under Section 151 (e) the grantor will lose his dependency exemption for any minor child who is over nineteen years of age and has more than $600 of income if the child is not a student, but
that the dependency exemption will continue even after the child has reached twenty-one if the child is a student and regardless of how much income the child may be making.

The greatest problem relates to the desire of the average grantor to qualify the child's income interest for the gift tax exclusion. Where the purpose of a trust is to provide for a child's college education, the 1964 Code effectively frustrates the establishment of a trust with a discretionary power in the trustees to accumulate income if it is desired to qualify the trust for the gift tax exclusion. At first blush, it would appear possible to accumulate income during the child's pre-college years and while the child is still under twenty-one, but a closer look at Section 2503(c) reveals that it has no application to a reversionary trust since not only must the income be paid over to the child upon becoming twenty-one, but also the principal. It is therefore necessary to include a mandatory distribution clause so far as the income is concerned, even during the child's minority.

The best way to handle this problem would appear to be to create a savings account for the child in the name of the child only and to insert a clause in the trust permitting the trustee either to pay the income to the child, or expend it on the child's behalf, or deposit it in any bank account which the child might maintain. This will permit the accumulation of the income outside of the trust during the pre-college years and the safekeeping of the money by the parents who presumably will have custody of the savings account book.

Another problem which the draftsman will encounter is a situation where the grantor has several children and wishes to create a single trust estate which will be used to take care of the college expenses of such of the children as are at the time in college. This cannot be done if the grantor is to obtain the benefit of separate gift tax exclusions for each child, since the gifts in favor of the pre-college children would be deemed future interests; and the only solution appears to be an immediate division of the trust estate into separate shares for each child with mandatory income distribution requirements. Furthermore it would appear hazardous to include any spendthrift provisions in such trusts.

One factor that should be kept in mind is that it is possible to provide for discretionary distributions of principal and still qualify for the exclusion by virtue of the new provisions of I.R.C. Section 2503(b). A possible form of dispositive clause for a grantor who wishes to create a college educational trust for his two sons to be divided into two shares and to be known as Trust Estates A and B follows:

"Until —, 1966, (a date more than ten years following the creation of the trust) or the date of the death of my son X, whichever of such dates shall first occur, the trustees are directed to pay to or expend on behalf of my said son the entire net income of Trust Estate A to provide for his advancement, college education and graduate school education, and after he reaches 21 years of age to provide for his support and maintenance; and I specifically direct that until he reaches 21 years of age, no portion of said net income shall be paid to or expended for the maintenance or support of my said son which either I or my wife, ——, are legally obligated to provide for. Any income which is not expended on my said son's behalf for the above purposes may be paid directly to him or may be deposited in any bank account which he may maintain. On ——, 1966 or the date of my said son's death, whichever date shall first occur, Trust Estate A shall revert absolutely to me, my heirs, executors, administrators and assigns, provided, however, that if my said son shall die prior to ——, 1966, and if on the date of his death my son Y shall be alive, there shall be no such reversion at that time, and in lieu thereof, Trust Estate A shall be added to Trust Estate B and shall be dealt with, administered and disposed of as an integral part thereof."

The reference in this clause to the legal obligation of the grantor's wife to support the child would appear to be desirable if the wife is one of the trustees. The provision for cross-remainders between the two trust estates, while not a requirement, is a useful feature where the income will not be sufficient to take care of all of the anticipated expenses of both children.

The short term reversionary trust of the type which is described above is by no means the only way of accomplishing the grantors' objectives. If he is willing to utilize his cumulative $30,000 gift tax exemption ($80,000 if his wife is living), or incur a relatively small gift tax if the exemption has been used up, he can create a much more flexible arrangement than the reversionary trust with mandatory income distribution requirements, particularly if the trust is set up early enough. For example, a grantor might set aside $10,000 for a child who has not yet reached his teens in a trust with the following features:

(a) The trust would be irrevocable and for the benefit of the child for life with a special testamentary power of appointment in the child exercisable in favor of the child's spouse and descendants, and with remainders over to other members of the family in default of appointment.

(b) The trustees would be two individuals who would be responsive to the wishes of the grantor and the child, and at least one of them would not be a relative or subordinate party, and they would have the power of terminating the trust at any time and paying over the trust corpus to the child.

(c) The trustees would have power to accumulate income, to take out life insurance on the child's life and to pay the premiums out of income.

(d) They would also have power to make discretionary distributions out of principal for the child's college education and advancement, and for the payment of life insurance premiums.

Under such a setup the trustees, until the child reaches college age, could utilize all of the income to pay the federal income tax thereon at low bracket rates and all or most of the balance to pay the premiums on life insurance on the child's life. After the child enters college, the income and all or a portion of the corpus could be used to pay college expenses and also the life insurance premiums, and the trust could be terminated by the independent trustees after the child has graduated and started to work, at which time the child will presumably be able to take care of premiums on the life insurance himself. On the other hand, if at that time there were sufficient assets in the family outside of the trust to take care of the college expenses, the trust...
could be continued for the child's life so as to permit the child to build up a fund which he could leave to his wife and descendants without federal estate-tax liability.

Because of possible changes in the tax laws and the circumstances of the beneficiaries, the power of termination in the trustees of a long term trust of this type is of great importance and imports a great deal of flexibility to the trust. To be sure, the grantor will not have the benefit of any $3,000 exclusion, nor will there be a reversionary interest to be excluded from the taxable gift, but saving taxes is not always the most important element in working out a plan in a situation such as this. Other advantages to this type of trust are that they may include a spendthrift clause, and, where there is more than one child, it may be set up as one fund for the benefit of the children successively as they enter college with a division of shares after the youngest child has completed his education. Furthermore, the trustees can be given so-called "spraying powers" as far as income is concerned, which cannot be done where the grantor insists on obtaining the $3,000 gift tax exclusion and which may turn out to be very useful if the trust is continued until the child is in high income tax brackets and has children of his own.

Consideration should be given to amending the law and the regulations to broaden the scope of Section 2503(c) with respect to accumulations in trusts for minors that can qualify for the $3,000 gift tax exclusion and to provide some guides and demarcation lines as to the expenditures which do or do not constitute support or maintenance of a beneficiary whom the grantor is legally obligated to support within the meaning of Section 677.

4. Use of Spray Trusts.

So-called "spray" or "sprinkling" trusts afford a useful embellishment on a trust of which one or more beneficiaries is a minor. A spray trust is generally described as one where the trustee has a power to select from amongst a named group of beneficiaries which beneficiary or beneficiaries shall be entitled to distributions of income and/or principal at that particular time or in that particular year. The discretion of the trustee is often expanded by permitting the trustee to decide the relative proportions in which distributions are to be made to beneficiaries.

The relative advantages and disadvantages of such trusts have been the subject of discussion. Settlers often avoid the use of such trusts because of the degree of control which passes to the trustee. On the other hand, some of the advantages of spray trusts include reduction of income taxes of the family group and broad flexibility. These advantages apply equally where minors are involved.

Since a substantial number of all inter vivos gifts to minors are sparked by a desire to effect a saving of income taxes, the advantages afforded by spray trusts make them particularly applicable in this field. In the ordinary situation, a parent makes a gift to a minor child in order to take advantage of the lower income tax bracket of the minor. In the absence of a spray trust, however, the amount of income to be distributed to a minor each year cannot be controlled. At most, it can be accumulated for the benefit of the minor through the medium of a trust or power in trust.

The spray trust, on the other hand, permits the trustee to take into consideration the income tax consequences in making his determination as to the members of the group to whom payments are to be made and the relative proportions in which distributions of income are to be effected. This power to control the incidence of the income tax presupposes, however, a trust which has been created in such a fashion that the income will not be taxed to the grantor. Particular attention should be given to some of the more apt to be forgotten sections of the Internal Revenue Code causing income to be taxed to the settlor. For example, income sprinkled for the support and maintenance of a beneficiary whom the grantor is legally obligated to support, will be taxed to the grantor. Other distributions to a minor would not necessarily be so proscribed. Similarly, the provisions of Section 677(a) would tax to the grantor the income of a spray trust of which the grantor was a possible income beneficiary.

If the trustee is subservient to the grantor, the spray trust merely becomes a medium through which the settlor annually distributes his income for maximum tax advantage. As could be expected, the Treasury Department has not permitted such an obvious loophole to exist. Thus, if a so-called non-adverse party, that is, one who has no beneficial interest in the trust which could be adversely affected by the exercise or non-exercise of the power, has power to determine the beneficial enjoyment of corpus or can dispose of income, the settlor will generally be treated as the owner.

A further danger inherent in the use of a trustee related to the grantor or a beneficiary is found in Section 678. Subdivision (c) thereof provides by implication that, to the extent that a trustee uses income for the support of one who he is legally obligated to support, the holder of the power that is the trustee individually, shall have the income taxed to him. Thus, if a husband names his wife as trustee of a spray trust of which their children are beneficiaries, then, to the extent that the wife applies income to the support of a child whom she is obligated to support, the trust income will be taxed to her. Subdivision (a) of the same section states the rule that anyone who has power to vest the income in himself will be taxed with respect to such income.

If, however, the trustee is in fact independent, that is, not related to the settlor or subservient to him, the mere possession of spray powers by the trustee will not result in taxing the income to the settlor. Moreover, if the power to spray is restricted by reasonably definite standards, the settlor similarly escapes income taxation. Thus, there obviously remains a broad area in which an alert independent trustee can effect substantial income tax savings in determining income distribution for the family group.

The powers of the trustee under a spray trust usually include the power to accumulate income, at least during the minority of the beneficiary in question.
Even those states which bar accumulations of income usually permit it during minority. Spray trust for minors therefore generally fall within the classification of so-called complex trusts. Deduction is given for amounts of income distributed and this income becomes taxable to the beneficiaries.

Since the trustee has discretion to accumulate, there is a small area in which further tax saving can be accomplished by accumulating in part and distributing in part. Thus, if the trustee partially accumulates and partially distributes income during the early years and then permits five years to elapse during which all or most of the income is distributed, an added tax benefit may be achieved by making use of the separate tax personality of the trust which exists under these limited circumstances.

From a flexibility viewpoint, spray trusts have the obvious advantage of placing money where it can best be used from an overall family viewpoint. The wisdom and dedication of the trustee are, in this instance, most important.

In a jurisdiction which follows the so-called two-life rule against perpetuities, spray trusts present an added problem if the group of beneficiaries, as it usually does, exceeds two in number. In a common law jurisdiction this problem is not present, since the life of the trust can usually be measured by the entire group of beneficiaries in esse. In a two-life jurisdiction, the problem can be solved, although not perfectly, by measuring the trust by the lives of the two youngest living beneficiaries.

Spray trusts should not be used indiscriminately but should be remembered as a device which can be effectively utilized in many situations.

III. SUGGESTED CHANGES IN CODE TO IMPLEMENT MAKING OF GIFTS TO MINORS

While the various developments hereinafter described have removed much uncertainty in the field of gifts to minors, there still remain many vexing problems. In view of the fact that the 1954 Code is still comparatively new, it would be too much to expect that Congress would now look with favor on numerous changes in the provisions that affect this subject. Apart from that, it would seem to be the part of wisdom to wait for experience to crystallize and bring into clearer focus the problems which still exist. But this does not preclude the making of suggestions for changes limited in scope and number.

The problem which seems to cry most loudly for solution at this particular time is the widespread view that some attempt should be made to aid the donor who feels that age 21 is too early to give absolute control over property to a child. But in making an attempt to achieve this end we should bear in mind that many feel that, while in the past there has been discrimination against gifts to minors, under the 1954 Code there is discrimination in favor of minors. It is felt that if Section 2503(c) were amended to read as is hereinafter set out, the objective of aiding a donor who does not want to turn over absolute control at too early an age would be achieved and at the same time the discrimination now existing in favor of minors would be removed. The suggested change would make Section 2503(c) read as follows:

"(c) Transfers until arrival at a specified age. — No part of a gift to any individual, whether minor or adult, shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom — (1) may be expended by, or for the benefit of, the donee until his arrival at some specified age, not exceeding years, and (2) will to the extent not so expended — (A) pass to the donee on his attaining the specified age, and (B) in the event the donee dies before attaining the specified age, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c)"

Any maximum specified age set forth in legislation will, at best, be more or less arbitrary. It should, to the extent possible, both recognize and reconcile the desire of parents not to place unfettered control over property in hands that are inexperienced and the desire of the Treasury Department and of the Congress not to lose substantial revenue. As to the former, few will question the desirability of safeguarding persons who have not reached a reasonable measure of maturity and experience because of their age; as to the loss of revenue, it is to a degree measurable but still substantially a matter of opinion and conjecture.


**NOTE: Special recognition is given to the members designated by an asterisk for the time, effort and subject matter contributed by them to the preparation of the foregoing report.**

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CASE HISTORY IN TAXES

- Missed by two weeks — The 13th Duke of Bedford holds one of England's oldest titles, and one of her biggest headaches — because his father died two weeks too soon. The 12th Duke had sought to save his son paying heavy inheritance taxes by turning over the property during his own life. But to be effective, he must live five years thereafter. He died in a hunting accident two weeks before the five years expired, and now the son has to get up $14 million in death duties.