Gift Tax Free Investment Accumulation Trust

IRREVOCABLE TRUSTS FOR CHILDREN OR GRANDCHILDREN aka Investment Accumulation Trust

One of the simplest ways to transfer wealth to family members is by taking advantage of the gift tax annual exclusion and the unified gift and estate tax credit. Two popular methods for making gifts to family members is through (i) use of custodian accounts and (ii) irrevocable trusts created for the benefit of children or grandchildren. Click here for a summary of the May 1997 Kohlsaat case “Crummey Powers Survive attack by IRS".

A. Tax Free Gifts - Click here for a graphic of projected tax savings

1. Annual Gift Tax Exclusion

   a. Every individual can gift $14,000 a year, free of tax, to as many individuals as the donor wishes. Thus, a husband and wife can gift $28,000 to each child and grandchild every year.

   b Certain types of gifts (i.e. gifts that have too many restrictions as to when the donee can get the benefit of such gifts) do not qualify for the annual exclusion.

   c. Gifts qualifying for the annual exclusion do not reduce the donee's unified gift and estate tax credit discussed below.

2. Lifetime Gift Tax Applicable Exclusion Amount

   a. In addition to the annual gift tax exclusion, an individual can gift up to the amount of the lifetime gift tax exclusion amount of $5,340,000 (beginning in 2014) during his or her lifetime free of tax. The gifts can be made to one or more individuals and can be applied to one or more gifts as long as the cumulative value of all gifts that exceeds the gift tax annual exclusion does not exceed the unified gift and estate tax credit equivalent during the donor's lifetime.

   b. The amount of the unified gift and estate tax credit not used during an individual's lifetime will shelter assets from estate tax upon the death of the individual.

   c. There are no restrictions on the types of gifts that qualify for the unified gift and estate tax credit.

   d. If a husband and wife's estate is properly structured, a husband and wife can pass up to $10,680,000 (beginning in 2014) of assets to their children by use of their combined unified gift and estate tax credit.

B. Custodianships

1. How Custodianships Operate

   a. A donor creates a custodianship that enables the designated custodian to distribute the custodial property to or for the use of a minor without court supervision.

b. Any types of property, real or personal, tangible or intangible, wherever located may be transferred to a custodial account.

c. When a minor beneficiary turns age 18, all property held in a custodial account must be transferred outright to the beneficiary unless, at the time the custodian account was created, the time for distribution was extended to when the beneficiary turns age 21.

d. If the gift to the custodial account was a testamentary gift, the custodianship may be extended to age 25.

e. If a minor beneficiary dies prior to termination of custodianship, the custodial property is distributed to the minor's estate.

2. Income Tax Consequences

a. A minor beneficiary reports all custodianship income directly his or her the income tax return. The custodian need not file a fiduciary income tax return.

b. If the minor beneficiary is under the age of 14, the income from the custodian account is taxed at the marginal income tax rate of the beneficiary's parents.

3. Gifts Tax Consequences

a. Often there is no gift tax consequences of making a gift to a custodial account because the gift qualifies for the annual gift tax exclusion.

b. Even if such gifts exceeded the annual gift tax exclusion, generally no gift tax would be payable although the donor will use a portion of his or her unified gift and estate tax credit.

4. Estate Tax Consequences

a. If properly structured, all the property held in the custodial account, including all the appreciation of such property, will pass to the beneficiary free of estate tax.

b. The custodial property may be included in the donor's estate if the donor was acting as custodian of the donated property at the time of the donor's death.

c. The custodial property may be included in the estate of the parents of the beneficiary when the parent was acting as custodian of the account if the custodial property was used to discharge the custodian's legal obligation as a parent to support the minor beneficiary.

C. Gifts to Irrevocable Trusts

Although custodial gifts are easy to create, the law governing custodianships may defeat some of the donor's objectives. In such cases it may be more beneficial to make the gifts to one or more irrevocable trusts created for the benefit of family members. Such trusts provide greater flexibility in determining how and when the beneficiaries receive the benefits of the property gifted. Click here for a graphic.

1. Disadvantages of Custodianship

a. A custodianship funded by a lifetime gift must terminate at the earlier of the minor attaining age 21 or the minor's death.

b. A custodianship can have only one custodian, while a trust may have co-trustees.

c. A custodianship can only be established for the benefit of one minor, while a trust can have several beneficiaries.

d. The donor cannot be the custodian without adverse estate tax consequences unless the donor elects to subject the custodianship to court supervision.

e. If the minor dies, the custodial property passes to his or her estate and thus is subject to probate costs and expenses.

f. Because a person under age 18 is generally not empowered to make a Will, the requirement that custodial property pass to the minor's estate will normally result in the property passing to the minor's parents.

2. Advantages of Gifts to Irrevocable Trusts vs. Custodian Accounts

a. Trusts can provide that the beneficiaries do not receive the ultimate distribution of trust property until certain age or ages that can be extended beyond age 21.

b. The donor can be the trustee of the trust and thereby retain control over the investment of trust assets, provided that someone else retains control over discretionary distributions to trust beneficiaries.

c. Trusts can provide that, if a beneficiary dies prior to receiving distribution of all trust assets, the assets of the trust can be distributed to other family members such as the beneficiary's issue rather than being distributed to the beneficiary's estate.

d. Trusts can provide that assets stay in trust for successive generations thereby taking advantage of the donor's one million dollar generation-skipping exemption.

e. Trusts can be created for multiple beneficiaries.

f. Trusts can be designed as a "grantor trusts," (described below) thereby enabling the grantor to be taxed on trust income.

3. Income Tax Consequences

Generally, the beneficiary pays income tax on all distributions of income made to the beneficiary. The trust pays income tax on all income that is accumulated in the trust. If the trust is designed as a "grantor trust," discussed below, the grantor is taxed on all trust income whether distributed or not.

4. Gift Tax ConsequencesThe grantor has made a completed gift of property transferred to the trust.

a. Often the trust contains withdrawal provisions ("Crummey" rights) to enable contributions to the trust to qualify for the annual gift tax exclusion.

b. Gifts in excess of the annual gift tax exclusion will reduce the Grantor's unified gift and estate tax credit.

5. Estate Tax Consequences

a. The property transferred in trust plus all income and appreciation on such property is removed from the Grantor's estate.

b. The trust can be designed with generation-skipping provisions so that property is not only excluded from the Grantor's estate but is also excluded from the estate of the Grantor's children.

D. Irrevocable "Grantor" Trust

An irrevocable grantor trust may enable a person to transfer assets, including those with built-in tax liabilities, in trust for the benefit of younger family members (or others) and to continue to pay the income taxes on the income generated by the assets transferred.

1. Typical Transaction

A Grantor desires to make a completed gift of real or personal property but because of one or more of the following factors, the Grantor wants the gift to be made in trust and wants to be treated as the owner of the property for income tax purposes. Such factors include: creating a qualified shareholder for an S corporation; facilitating the transfer of an installment note with built-in gain; transferring property with liabilities in excess of tax basis; preserving tax attributes which the Grantor may have (e.g. reinvestment rights and capital gain exemption on the sale of a personal residence); allowing income tax-free exchange on sales between the trust and the Grantor; planning for the sale or other transfer of life insurance policies; reducing the value of the Grantor's estate.

2. Tax Consequences

a. Income Tax Consequences.The Grantor is taxed on all of the income generated by the trust property regardless of whether the income is retained in trust or distributed to the beneficiary. (Note: the trust may be designed to allow termination of the grantor trust provisions if circumstances change.)

b. Gift Tax Consequences.The Grantor has made a completed gift of the property transferred to the trust.

(1) Often the trust contains withdrawal provisions ("Crummey" rights) to enable contributions to the trust to qualify for the annual gift tax exclusion.

(2) Gifts in excess of the annual gift tax exclusion will reduce the Grantor's unified gift and estate tax credit.

(3) Payment of the income taxes by the Grantor on property retained by the trust or distributed to the beneficiary should not be deemed to be a gift to or for the benefit of the trust or its beneficiary since the Grantor is primarily obligated to pay the income tax. Caveat: the IRS may attempt to treat the payment of income taxes by the Grantor as an additional gift to the trust beneficiary but this position has been almost uniformly criticized by commentators and practitioners.

c. Estate Tax Consequences.

The property transferred in trust plus all income and appreciation on such property is removed from the Grantor's estate.(1) Since income taxes are paid by the Grantor, a greater amount will pass to the trust beneficiary.(2) The income taxes paid by the Grantor reduce the Grantor's estate.