Making gifts to minors

When thinking about making gifts to your children or other minors, the tax consequences must be evaluated very carefully. Many times, the tax consequences can be beneficial and lower your tax bill.

Different strategies, whether used alone or in combination, can produce the most advantageous tax results for you and the recipients of your generosity. However, everyone's situation is unique so before you start making gifts, talk to a tax professional.

Basic considerations

- A minor is any person under age 18.
- Different tax rules apply to gifts to minors under age 18 and minors under age 14.
- In general, the unearned income exceeding $1,500 (the 2002 amount) of a minor who is under 14 years of age will be taxed at the highest marginal rate of his or her parents.
- Income from property given to a minor who is 14 years old or older will be taxed at the minor's marginal income tax rate.
- If a minor's gift is in trust, there is a 15 percent tax rate on the first $1,850 (the 2002 amount) each year that grows in the trust.

Estate tax

The tax on your estate is determined at the time of your death. Making gifts is often overlooked and undervalued as a way to reduce your estate tax. When you make gifts of money or property during your life the net result is a smaller estate and a smaller tax.

Annual Exclusion

In general, you can give away up to $11,000 to anyone (including minors) during the year, and this amount is tax-free. You and your spouse can each give annually $11,000 tax-free. One spouse can also give up to $22,000, which the other spouse can agree to "split," giving the same result as the first case.

When you give a minor a property gift that later increases in value, your estate will not be taxed on this increase in value.

For estates having one or more family businesses' stock, redeeming the stock after the estate owner's death can help lower the tax bill. One requirement is that the stock that is included in the estate of the deceased estate owner has to have a value that is greater than 35 percent of the entire estate's value (minus such things as losses and debts). If the owner had made gifts of assets while he or she was alive (other than gifts of the stock)—such as to minors—this will make the percentage that the stock bears to the estate larger upon the death of its owner.

UGMA/UTMA accounts

Under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), annual gifts can be made by individuals to a custodial account.

Tax-free gifts can be made under the UGMA. In 2002, each taxpayer can transfer up to $11,000—and each married couple can transfer up to $22,000—to a custodial account. Some of the earnings will receive tax exemption while some or all of the earnings will receive taxation at the minor's tax rate. One drawback to UGMA accounts, however, is that the gifts are irrevocable.

Another drawback is that if a student applies for financial aid, UGMA accounts may be deemed assets of the student that are part of the student's contribution toward his or her educational expenses.

UGMA and UTMA accounts have another downside that many parents dislike. When the minor reaches 18 or 21 years of age (depending upon state law), he or she can do whatever he or she wants with the custodial account money. (That's why some individuals prefer "Crummey" trusts, which are discussed below.)

UTMA accounts operate very similarly to UGMA accounts. However, UTMA accounts let individuals make property gifts to their children that are tax-free.

Trusts

If you use property that does not produce income (such as a life insurance policy) to fund a minor's trust, this can have bad tax consequences. The IRS could assert that the true value of the gift cannot be determined, causing unavailability of the annual exclusion.

With a "Crummey" trust, your gift can stay in trust for as long as you desire without giving up the annual exclusion. However, contributions to a "Crummey" trust do not qualify for the annual exclusion unless the beneficiary receives notification that the contributions were made and is given a limited time (usually 30 days) to withdraw the contribution.

It is understood that the beneficiary will not withdraw the money or property. However, such an understanding should not be written because the IRS will use any evidence to say that the beneficiary had no withdrawal power.

If you are planning to make some gifts to your children or other minors, contact the office for additional guidance so we can make sure you get the best tax breaks possible.