

# The National Association of Financial and Estate Planning

## MEMORANDUM – PREMIER III CHILDREN’S/GIFTING TRUST

TO: Trustees And Trust Officers

SUBJECT: Administration And Taxation Of \_\_\_\_\_

**Note:** This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal or accounting services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

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This trust is an irrevocable, non-grantor, "Crummey" trust. As a non-grantor trust, all property which the grantor places in the trust is an immediate and complete gift to the trust beneficiaries, with no strings attached by the grantor. A brief discussion of the mechanics of this trust is as follows:

**Irrevocability.** The grantor can not take anything back after putting it into the trust, cannot change the beneficiaries in any way, cannot control the distribution of income or principal to any beneficiary, and cannot control the trust in any way. If the grantor violates anything mentioned in the previous sentence, the trust can be held to be a "grantor" type by the IRS, all the transfers to it would be invalidated as gifts, and all the gifts would be included in the grantor's taxable estate.

**Gift Taxes.** Since the grantor does not own or control the property in anyway when it goes into the trust, anything the grantor puts into the trust is subject to gift tax laws. This trust is designed to allow certain transfers to it to be considered as "gifts of a present interest". This is important because only gifts of a present interest are eligible for the annual gift tax exclusion (\$10,000 per donor per donee).

If the grantors want to make larger gifts than the 10,000.00 per donor per donee limit, they may do so and use their unified gift and estate tax exemption of \$650,000 to \$1,000,000 per donor. Any amount of gift over the 10,000.00/20,000.00 annual exclusion should be treated as gifts of a "future interest" because the beneficiary does not have immediate and complete withdrawal rights. These type gifts will be immediately subject to the terms and provisions of the trust, rather than having to wait 30 days. That is OK, and not a problem. In fact the future interest portion may be discountable in value due to the beneficiary's lack of

marketability and lack of control over the gift (see next topic).

**Gift Valuations.** Future interest gifts, in excess of the annual exclusion gifts, may be discountable or valued less than the fair market value for purposes of calculating its gift taxable value. The revaluation could be in the form of a future value calculation, based on the time delay before the beneficiaries receive distributions. Or the revaluation may in the form of the valuation of an income stream if the beneficiaries receive an income only, rather than outright distributions. The value of the gift depends upon the dispositive arrangements. Any revaluation decisions of the gifted amount must be recommended by the grantor's tax counsel. No attempt will be made here to discuss the amounts or methods of revaluation because of the depth of that subject.

**Special Note on Income Taxes.** Since the beneficiary of the trust, through the utilization of the Crummey provision, is deemed by the IRS to have a power of appointment, the beneficiary will be treated as the owner of that portion of the trust which is subject to his or her withdrawal right. This means that the beneficiaries are not merely passive recipients of the income, but they are treated as the owners of the source of the income, the trust assets. It is as if the trust does not exist for income tax purpose. The trust does not simply report income and deductions on its return and then allocate the net to the beneficiaries. The trust is treated as a 100% grantor trust and the beneficiaries treated as if they are the grantors. Each beneficiary must include his pro-rata share of all items of income, capital gains, deduction and credit on his or her tax return. (The amount that a beneficiary owns is the percentage or share specified in Section 10 of the trust.) Please note however, if any trust income is used to pay premiums insuring the life of anyone, that

income must be taxable to the insured. For this reason, it is best to have someone other than the insured be the grantor. Any beneficiary under the age of 14 will be subject to the "Kiddie tax" rules. This means that the young beneficiary's trust income will be taxed at his/her parents' rate, not at their own rate.

Any capital assets transferred to the trust will retain the same basis that the transferor had in the asset, and the two year rule on paying the capital gains tax at the donor's rate is in effect (IRC Section 644).

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**Crummey Trust.** The name "Crummey" comes from a 1968 Ninth Circuit court case involving the IRS vs. Mr. Crummey. This court ruling allows a trust to give a notice to each beneficiary whenever a present interest gift has been transferred into the trust. The notice gives each beneficiary 30 days in which to claim any part of the present interest gift, up to the limit of the \$10,000.00/20,000.00 per year rule. The beneficiary must have an absolute right to claim up to the limits of the gifted amount. If the beneficiary fails to claim any of the gift, the funds are retained in the trust and administered according to its terms (primarily Section 17 of the Trust). The effect of the notice procedure is that the gift becomes a "present interest" and qualifies for the annual gift tax exclusion.

Most clients/grantors will want to have a discussion with the over age 21 beneficiaries and explain what they would like to have accomplished with trust funds. They will want to let the beneficiaries know that withdrawing their gift is completely legal and proper. But, it will hamper the grantors' estate planning, and further gifts probably would not be made in behalf of any beneficiary who withdraws one. Children under the age of 21 cannot make a withdrawal due to their

minority status. The trustee is in charge of their right to withdraw, and will let the withdrawal right lapse.

A form letter "Crummey" notice is included with the trust. The letter must be faithfully sent out to adult beneficiaries by the trustee/trust officer every time a present interests gift is made to the trust. If the trustee/trust officer anticipates difficulty in getting acknowledgements of the notice back from the beneficiaries (see the sample letter), he or she should send the notices by registered mail, return receipt requested. Notices do not have to go to beneficiaries under age 21, because the trust makes the trustee the guardian of these underage (and also mentally incompetent) beneficiaries for trust business only. It therefore isn't necessary for the trustee to send himself, as the legal guardian, the notice. The trustee may keep the money for these beneficiaries in the trust through the 30 day period, and beyond, with no notice and no problems. Any beneficiary over the age of 21 will have to get the Crummey notices, however.

**Separate Shares.** The trustee/trust officer must use some procedure to account for each beneficiary's share separately. There must be, in effect, a separate account in the trust for each beneficiary. Funds held for one beneficiary can never be given to another beneficiary. Any transfers into the trust must be immediately separated into equal shares for each of the beneficiaries. A breach of these requirements not only violates the trustee's fiduciary responsibilities, but has negative gift tax implications as well. All the shares can be co-mingled for the most efficient investment management (investment of all funds in one investment or one investment account), but the value of each beneficiary's share must be separately identifiable.

**Read the Trust.** There are many vital and specific benefits, provisions, and requirements in the trust that are not discussed here. They should be self-explanatory, but don't hesitate to call NAFEP for information.