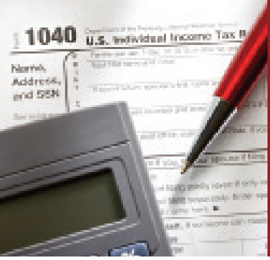

COMMITTEE REPORT: ESTATE PLANNING & TAXATION

By **Kristen A. Curatolo** & **David A. Handler**

Help—My Child is About to Receive A Windfall!

How to handle oversized minor's trusts and custodial accounts

We all know about "*Crummey* trusts" as a way to make annual exclusion gifts to children.[1] In such trusts, the child has the right to withdraw each annual gift made to the trust for a limited period of time, after which the right lapses and the assets are governed by the trust terms. Internal Revenue Code Section 2503(c) creates another option for annual exclusion gifts made for minor children. In an IRC Section 2503(c) trust (2503(c) trust) (also known as an "irrevocable minor's trust"), there's no annual withdrawal right; instead, gifts for the minor child qualify for the gift tax annual exclusion if the child has the right to withdraw all of the trust assets at age 21—even if for a limited time.[2]

Most assume that 2503(c) trusts will give the child the right to withdraw a relatively modest sum at age 21, but sometimes this planning takes an unexpected turn when the assets in the trust balloon to an astronomical value. A similar situation emerges with custodial accounts such as Uniform Transfers to Minors Act (UTMA) or Uniform Gifts to Minors Act accounts (collectively, UTMA accounts). Creatures of state law, UTMA accounts give the child-beneficiary complete control over all assets at ages 18 to 25.[3] In the years, weeks or days before the child's birthday that will give them ownership of the assets, clients snap to attention and make hurried calls to their estate-planning lawyers and wealth advisors to find a way to put the brakes on the child receiving a windfall at an early age.

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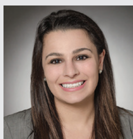


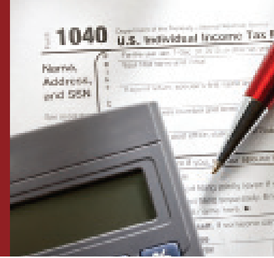
Often, the client gave little thought to the structure of the gift because the amount seemed inconsequential at the time. For example, if a parent regularly makes annual exclusion gifts to a 2503(c) trust or UTMA, this adds up to $315,000, and if that generous parent splits those gifts with their spouse, that amount doubles to over $630,000. If a 2503(c) trust or UTMA owns an appreciating asset (such as stock in a start-up), that amount could skyrocket to millions.

Let's discuss solutions for estate planners and wealth advisors to present to their clients who have oversized 2503(c) trusts and UTMA accounts for minor beneficiaries.

Irrevocable Revocable Trust

Practitioners are aware of the benefits that a typical revocable trust offers, which include privacy, autonomy and administrative ease. A revocable trust keeps the disposition of the client's assets private because, unlike a will, it isn't filed with the probate court at the client's death and doesn't become a public document. A trust created under a revocable trust isn't subject to the continuing supervision of the probate court. If the client becomes incapacitated, the trustee of his revocable trust can manage assets owned by the trust without a court-appointed guardian.

An "irrevocable" revocable trust has all these benefits with the added layer of prolonging a parent's control over the funds. Under this structure, on reaching age 21, the child agrees to withdraw the funds from the 2503(c) trust or UTMA account and immediately contribute them to a revocable trust of which their parent(s) are the trustee(s). This revocable trust provides that the child may amend or revoke the trust or replace the trustee only with written consent of the parent until the child attains a certain age or the parent(s) are deceased or incapacitated. At an



age set forth in the trust (the control age), the trust is no longer "irrevocable," and the child may become trustee and amend or revoke the trust at will.

For example, Mom funded a 2503(c) trust for the benefit of Son with stock in her company over many years. Mom's company is successful, and on Son's 21st birthday, the trust is valued at $5 million. Mom has a meaningful conversation with Son about the value of the trust and the importance of proper asset management (and that if Son cooperates, there's plenty more where that came from—and if he doesn't, there may be none). On Son's 21st birthday, he withdraws the funds from the 2503(c) trust and contributes those assets to a new revocable trust he establishes. The revocable trust provides that Son may not amend or revoke the trust, or appoint and remove trustees, until the earlier to occur of Mom's death or his 35th birthday. Mom is the initial trustee and manages all the trust assets and controls distributions. The trust also includes a testamentary general power of appointment where, on Son's death, he may direct the trustee to distribute the trust property to or in trust for anyone he chooses. Mom may retain the right to adjust the age when Son gains control of the trust.

This strategy requires the cooperation and participation of the child-beneficiary. In our experience, a child-beneficiary cooperates after being gently reminded that their education, housing and all other expenses are being funded by their parents. The parents might also mention that the child stands to inherit a lot more in the future and that could be changed with a pen stroke, but some clients aren't prepared to have that discussion with a 21 year old (more on that below). The client may also compromise with the child-beneficiary by allowing them to keep a certain amount of the funds while transferring the balance to an irrevocable revocable trust.

LLCs and Limited Partnerships

Prior to the child-beneficiary reaching age 21, a trustee of a 2503(c) trust may contribute the trust property to a limited liability company (LLC) or limited partnership in exchange for an LLC ownership interest or partnership interest. Likewise, UTMA law provides that a custodian may "invest the custodial property," which means a custodian of a UTMA account may do the same.

The terms of the LLC's operating agreement or the partnership agreement typically restrict transfers and withdrawals and have a manager control distributions. The LLC manager may make distributions to the child-beneficiary on a schedule that the manager deems more appropriate or choose to keep all assets within the entity to ensure proper asset management and creditor protection.

For example, assume Mom created a UTMA account for the benefit of her child, which grew in value to $1 million. Mom, as the custodian of the UTMA account, may invest all of the custodial assets in an LLC before her child's 21st birthday. The LLC's operating agreement provides that a trusted third party (such as another family member or friend) is the manager of the LLC, and all distributions are made in the manager's discretion.[4] On the child's 21st birthday, the child receives an interest in the LLC (perhaps even 100% of the LLC).

Clients can use this situation as a pivotal teaching moment for the child.

This structure could end here, or Mom could then work with the child to set up an irrevocable revocable trust, of which Mom is the current trustee but the child may become trustee and receive complete access to the trust property at age 35. Mom is able to control the timing of distributions and manage investments while giving her child a pathway to ownership of the assets at a more appropriate age.

Investing Assets to Reduce Liquidity

As noted above, the trustee of a 2503(c) trust and a custodian of a UTMA account both have the ability to invest assets. Rather than contributing assets to an LLC, the trustee or custodian could instead invest in illiquid assets such as real estate, art, private equity or venture capital funds or private companies. Essentially, this may include investing in any property that can't be sold quickly due to

restrictions associated with the investment, a shortage of interested buyers or a lack of an established trading market. The trustee or custodian should keep in mind that they're serving in a fiduciary capacity, which means they have a legal responsibility to manage and invest the assets as a reasonably prudent person would (and that standard may be raised even higher for a trustee or custodian that's sophisticated and has expertise in investing). This means that the fiduciary shouldn't run out and buy 500 acres of farmland in Oklahoma without carefully determining whether it's a good investment. Otherwise, the child-beneficiary may seek to hold the fiduciary liable for negligently managing the assets.

The remedies for an oversized custodial account or 2503(c) trust aren't "one-size-fits-all."

Seizing a Teaching Moment

Some clients may panic at the thought of their child discovering that they have access to a small fortune on their 21st birthday. Clients worry that their child will lose motivation and ambition or will quickly squander the money on bad investments and frivolous purchases. Alternatively, clients can use this situation as a pivotal teaching moment for the child. This is especially true if the amount available to the child is a small portion of the overall wealth that they'll enjoy some day through an inheritance. If the amount available to the child is reasonable and the child is thoughtful and mature, this access may give the child the opportunity to demonstrate that they're financially responsible and trustworthy. The client may view this as a chance to "see what happens" with a relatively small amount.

If the child-beneficiary has started working and is receiving a paycheck, they may consider withdrawing money from the 2503(c) trust or UTMA account and contributing those funds to a Roth individual retirement account, which would allow the assets to grow tax free and compound over time. While the maximum contribution allowed to a Roth IRA for 2021 is $6,000, making annual contributions to the Roth IRA will lay a meaningful foundation for the child's future retirement income. The parent can explain how tax-free compounding can add up to millions of dollars in the future.

The child-beneficiary may also use this opportunity to use their heightened gift tax exemption amount of $11.7 million, which is set to sunset at the end of 2025. The child may transfer cash to an irrevocable grantor trust created by the child for the benefit of family members (including their future descendants), with the ability for an independent trustee to later add the child's future spouse as a beneficiary. If assets available to the child also include securities that may appreciate in value, the child may take advantage of the historically low IRC Section 7520 rate and create grantor retained annuity trusts that squeeze the appreciation from the underlying assets gift tax free into their irrevocable grantor trust. By implementing these wealth transfer techniques early on, the child-beneficiary is getting a head start on building wealth that's outside of their taxable estate.

The remedies for an oversized custodial account or 2503(c) trust aren't "one-size-fits-all." When arriving at a solution, practitioners should evaluate the maturity and responsibility of the child-beneficiary and measure family dynamics. For a responsible young adult, the planning opportunities can be tremendous. For an obstinate one, it may be an exercise of protecting the child-beneficiary from themself for as long as possible.

Endnotes

1. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).
2. The following withdrawal periods have been allowed: Treasury Regulations Section 26.2612-1(f), Example 3 (60 days); Revenue Ruling 83-108 (1983) (45 days); *Estate of Lieselotte Kohlsaat*, T.C. Memo. 1997-212 (1997) (30 days); *Israel Mikel, et ux. v. Comm'r*, T.C. Memo. 2015-64 (2015) (30 days); *Cristofani v. Comm'r*, 97 T.C. 74 (1991) (15 days).
3. For purposes of this article, the authors assume the Uniform Transfers to Minors Act (UTMA) account will become distributable at age 21.
4. Internal Revenue Code Section 2036 requires the inclusion in a decedent's estate of the value of property in which the decedent retained a lifetime income interest or the right to the possession or enjoyment of the property. Ideally, a parent shouldn't be the manager of the limited liability company (LLC) to avoid an IRC Section 2036 argument or the child-beneficiary claiming the parent is using the LLC as a way to impermissibly extend the parent's control over UTMA assets.