Trust Protection for Gifts to Children and Grandchildren

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Although there is near universal acceptance of the importance of gifting, the manner in which gifts are made can have a major impact for your beneficiaries. This is particularly true if the recipient is under 21 years of age, and it can be an acute issue if the recipient is a minor under the age of 18.

Outright gifts to children and grandchildren have their own drawbacks, including limited control over the gifts made, exposure to creditors, divorce, and other issues involving the beneficiary. For these reasons, trust options should be considered to afford greater protection and structure for your beneficiaries.

Outright Gifts and Custodial Accounts Have Significant Drawbacks

Gifting assets outright to a beneficiary exposes the gift to a number of risks. Outright gifts are subject to the beneficiary’s creditors and may be at increased risk in the event of a divorce. If the beneficiary dies and has an inadequate estate plan, unexpected beneficiaries could receive those assets, or other problems may arise.

When the gift recipient is a minor, a custodial account (or UTMA) offers some structure, but the flexibility of a custodial account comes with major drawbacks. In New Jersey, custodial accounts terminate upon the recipient turning 21, and in some instances when they turn 18. Upon termination, all assets held in the custodial account are given over to the recipient, including all investment and management decisions. Once this occurs, there is nothing stopping the recipient from squandering the custodial account or making poor investment decisions.

For example, suppose that annual exclusion gifts in the amount of $15,000 per year are placed into a custodial account beginning at age 9 and ending at age 18. Even if the gifts earn a 0% rate of return, the custodial account will still be holding $150,000. Upon the recipient turning 21, all $150,000 in the custodial account will be turned over to the recipient.

Another issue, and one frequently experienced, is the change of custodians upon the death or incapacity of the custodian before the recipient turns 21. The UTMA permits the primary custodian to name a successor if the primary custodian is no longer available. This option is not always exercised by the custodian, and may result in difficult and overly burdensome transitions to a successor custodian. Until the new custodian is accepted, the custodial account has no one to manage the
investments or assets held in the account.

**Trust Options for Gifts**

Trust option should be considered in lieu of an outright gift, a transfer to a 529 Plan, or a transfer to a custodial account. Trust options include 2503(c) Minor’s Trusts and irrevocable gifting trusts. These trusts allow assets to be used for a wider variety of needs including medical expenses or the purchase of a first house, which are not allowed by a 529 Plan. They also provide more structure than a custodial account, and the trustee can continue to manage assets beyond age 21, if properly structured.

2503(c) Minor’s Trusts can be used for annual exclusion gifts made to recipients under age 21. These trusts are named for Internal Revenue Code Section 2503(c), which requires that the assets of the trust be applied for the minor who is a beneficiary of the trust with limited exceptions. The trust can only have one beneficiary who must be under the age of 21. Upon the beneficiary turning 21, the beneficiary must be afforded an opportunity to withdraw the assets of the trust. Any assets that are not so withdrawn can be retained in trust, and the trust converted into another form of irrevocable trust which allows for continued annual exclusion gifts to be made for the beneficiary.

2503(c) Trusts are managed by a trustee who is chosen by the person who creates the trust, usually the recipient’s parent or grandparent. This provides structure and a suitable person to manage the assets held in trust. If there is an issue with the primary trustee, an alternate trustee can be designated to assume control over the trust.

For those interested in more structure than that afforded by a 2503(c) Minor’s Trust, an irrevocable gift trust will make a sensible addition to their estate plan. Irrevocable gifting trusts can be used for annual exclusion gifts and are highly recommended for larger gifts that require a Gift Tax Return (Form 709). As with other forms of trusts, the person creating an irrevocable gifting trust appoints the trustees, and can name alternates if the primary trustee is unavailable for any reason. The trustees have broad authority to manage the assets for the recipient including discretion over distributions to the beneficiaries. Unlike 2503(c) Minor’s Trusts, irrevocable gifting trusts do not have to terminate or require unrestricted access to trust income or principal. In addition, irrevocable gifting trusts can provide enhanced asset protection, and afford the option of generation skipping planning for grandchildren and more remote descendants.

In conclusion, outright gifting has significant drawbacks and risks. Assets can be squandered, subjected to marital issues, or result in other unanticipated problems. Trust options, including 2503(c) Minor’s Trusts and irrevocable gifting trusts, exist to deal with these issues while allowing for annual exclusion gifts or larger transfers. Trusts provide enhanced protection and structure for gifted assets, while affording the trustee discretion to make distributions for the beneficiary.

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