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Practice Alert: Drafting Suggestions for §2503(c) Trusts

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Small gifts made annually have long been excluded from taxable gifts under the federal gift tax. [1] This annual allowance is expressed as a fixed dollar amount that may be given by a donor to a donee within a calendar year without creating a taxable gift. [2] Using these exclusions wisely is one of the persistent challenges of practice in this area. This article examines that challenge in the context of gifts to minors with particular focus on the statutory exception for trusts for the benefit of minors under Code Sec. 2503(c) .

Legal Background

The language of Code Sec. 2503(b) requires that annual exclusion gifts not be "future" interests. [3] Generally, outright gifts are not "future" interests, but most interests held by beneficiaries [4] in a trust are forbidden "future" interests. A few exceptions are immediate income interests and property subject to an immediately exercisable power of appointment in favor of the donee, both of which are not "future" interests. [5]

Gifts to minors, however, created difficulties from the outset. Because minors are not legally capable of owning property themselves, serious questions were raised whether any gift to a minor could qualify as "not a future" interest. [6] The Supreme Court's decision in *Fondren* [7] was hardly comforting on this matter. That Court held that it was not a matter of whether an interest was vested in a property rights sense, but rather, "The question is of time, not when title vests, but when enjoyment begins." [8] Since "enjoyment" for a minor might be thought to begin only on emancipation, [9] even outright gifts to minors might not qualify as non-future interests since a guardian would be required to own the property until emancipation. [10]

Other difficulties surrounding gifts to minors included the fact that trusts were far superior vehicles for gifts to minors than guardianships and those interests were generally future interests, as pointed out above.

While the IRS moved to comfort taxpayers making outright gifts to minors, [11] Congress attempted to provide an area of certainty regarding gifts to minors by statute. Code Sec. 2503(c) , added in 1954, provides that a gift to a trust for the benefit of a minor is "not a future interest" if the trust meets three statutory requirements:

(1) *The Benefit Requirement.* The property and the income may be expended for the minor's benefit; and

(2) *The Passing Requirement.* The property and the income therefrom will to the extent not so expended pass to the minor at age 21; and

(3) *The Contingent Payment Requirement.* If the minor dies prior to attaining age 21, the property and the income therefrom will be payable to the minor's estate or as the minor may appoint under a general power of appointment.

Legal Requirements of 2503(c)

None of the above requirements has survived the 45 years since enactment unscathed. This section summarizes the developments relating to each requirement during that period.

A. The Benefit Requirement.

This requirement has been the most strictly enforced. Since the requirement that the funds in the trust be available for the unfettered benefit of the minor was the keystone of Congressional intent in enacting this statute, that enforcement is altogether understandable.

The Regulations require that no "substantial restriction" be imposed on the trustee's discretion. [12] *Ross v. United States* [13] permitted an exclusion under Section 2503(c) when the trustee was directed to administer the property "as if [the Trustee] were the guardian of the beneficiary's person and estate" and Rev Rul 69-345 [14] seemed to endorse that standard by judging (at least in part) the range of permissible restrictions by reference to the powers of a guardian under state law. These two propositions-that there must be no "substantial restrictions" and that any restrictions can be no greater than those imposed on a guardian under applicable state law-today form the basis for analyzing trust restrictions under Code Sec. 2503(c) 's benefit requirement.

Nonetheless, a few modifications have been permitted. Rev Rul 67-270 , [15] permitted a trust providing for "support, care, education, comfort and welfare" to qualify as within the benefit requirement and the Tax Court permitted "education, comfort and support" in *Heidrich v. Comm'r.* [16] The Court of Claims reached the edge of this small envelope, however, in *Williams v. United States* [17] when it permitted "maintenance, education, medical care, support and general welfare...if the cost and expense incident thereto are not otherwise adequately provided for..."

Crucial to all of the above decisions was the fact that none of the standards utilized in those cases was legally ascertainable [18] and therefore no "substantial restriction" under the Regulations [19] was presented. Consider, for example, *Illinois National Bank of Springfield v. United States* [20] in which the trustee could use principal only for "education, accident, illness or disability of the beneficiary." In that case, the restriction was held to disqualify the trust under Code Sec. 2503(c) 's benefit requirement.

That analysis leads to the question whether every ascertainable standard by its nature violates Code Sec. 2503(c) 's benefit requirement. While there is no direct authority, this author believes that any ascertainable standard violates Code Sec. 2503(c) 's benefit requirement since "benefit" is unlimited and unascertainable. An ascertainable standard seems to restrict "benefit" to the "ascertainable" by its very nature and such a restriction can hardly be thought not to be a "substantial restriction" under the Regulations. [21]

Another aspect of the benefit requirement is the contingent nature of the payments. This was addressed in Rev Rul 69-345 [22] wherein the trust provided that the permissible purposes of the trust ("care, support, education and welfare") could only be satisfied from the trust when other resources were unavailable to the beneficiary. Since the beneficiary's parents "owned considerable property and had other sources of income more than sufficient to meet their legal obligation for his support," the Service concluded that the above provision imposed an effective condition precedent that is not satisfied and hence "imposes a substantial restriction on the trustee's power to use the property for the minor's benefit..."

At the present time, the settled wisdom seems to be that imposing express restrictions of any sort is simply not worth the risk and uncertainty. The result is that most practitioners today simply state that trust distributions may be made for the minor's benefit and leave it at that. This clearly qualifies and leaves the trustee to applicable state law (the maximum measure of permissible powers under *Ross* and Rev Rul 69-345 anyway) when the trustee wishes to resist making distributions.

The benefit requirement has been applied separately to principal and income. [23] This permits qualifying only the income for the exclusion under Code Sec. 2503(c) . The advantage is that the principal is not subject to the minor's withdrawal power at age 21. Instead, only the current and accumulated income is subject to the minor's withdrawal power at age 21. Of course, the excess of the value of the principal over the value of the income interest will be a future interest and will not qualify for the annual exclusion under Code Sec. 2503(c) .

B. The Passing Requirement.

The requirement that the trust property pass to the beneficiary at age 21 has been substantially ameliorated. First, Rev Rul 59-357 [24] held that the restrictions of Code Sec. 2503(c) are the maximum restrictions and that therefore payments to the minor *earlier* than those required in the statute are permitted. [25]

Second and more important, Rev Rul 74-43 [26] reconsidered and revoked Rev Rul 60-218 . [27] This permitted a trust to qualify under Code Sec. 2503(c) if the trust provided the beneficiary with the right to demand the trust property for a reasonable period of time [28] at age 21. Thereafter, the trust could continue until some other time as stated in the trust, rather than terminating altogether as Rev Rul 60-218 had required.

While no immediate estate or gift tax advantage is permitted by this expansion, [29] substantial creditor protections are enabled, depending on applicable state law. While some states may treat property that has been subject to a general power of appointment in favor of the beneficiary and that has lapsed as subject to the claims of his or her creditors (depending in part on whether the lapse of the power is treated as a "transfer" in fraud of creditors), most will not and many such lapses will not be in fraud of creditors even where that standard is applicable.

This permits, for example, a beneficiary to keep the property in the trust from being commingled with the beneficiary's and the beneficiary's spouses' property and thus permits avoiding equitable distribution of the trust property on divorce. [30] While the beneficiary may be permitted to act as his or her own trustee, again depending on applicable state law, estate tax inclusion will not be altered.

The passing requirement embodies a significant disadvantage in that each trust qualifying under Code Sec. 2503(c) can have only a single beneficiary during the minority of the intended donee. Otherwise, there could be no assurance that the property will, to the extent not expended for the minor-donee's benefit during minority, pass to the beneficiary at age 21 instead of being paid to one of the other beneficiaries. [31]

C. The Contingent Payment Requirement.

This requirement is expressly made contingent on the death of the beneficiary during minority ("in the event the donee dies before attaining the age of 21 years"). As such, private letter rulings have held that this requirement need only be satisfied during the beneficiary's minority. [32]

Similar to the satisfaction of the passing requirement with a general power of appointment in favor of the beneficiary, this liberalization also does not alter the immediate estate or gift tax consequences but does enable substantial creditor protections, dependent on state law. Once the beneficiary is not under age 21 and after any power to demand the property has terminated, the beneficiary's creditors, both domestic and commercial, may encounter substantial difficulties in attaching the property still in the trust.

Comparing 2503(c) Trusts to Crummey Trusts

A. Major Advantages of Code Sec. 2503(c) Trusts

As compared to trusts using withdrawal powers to qualify gifts for the annual exclusion, the major advantages of Code Sec. 2503(c) trusts are (1) the much simpler annual administration of the trust, (2) some drafting simplifications and (3) the statutory certainty of the tax results, given compliance with the requirements. Annual administration would consist of simply making the gifts and (perhaps) reporting them. Gifts made to such trusts in amounts equal to or less than the annual exclusion amounts will automatically qualify both for the gift tax and the generation skipping tax annual exclusions. Since allocations of generation skipping tax will not be required, the brave may even be tempted to forego filing gift tax returns altogether.

Since there would be no more Crummey notices to beneficiaries, gifts could be made without notifying the beneficiaries at all, obviating both explanations of the notices and engendering feelings in the beneficiaries that perhaps they are better off than others. Since there would be no more notices, it would not be necessary to calculate the amount of each gift subject to each power-holder's power. It would also not be necessary to determine whether and to what extent the "five and five" annual lapse amount had been already used nor the amount by which any remaining "five and five" lapse amount would be used if the power were not exercised over each gift. There would be no questions as to aggregation of those lapses. There would be no more required accounting for each of those lapses nor for the remaining hanging power amounts. And there would be no more duplicitous applications of generation skipping tax exemption on a power-holder's death. From a drafting and tax certainty point of view, there will be no more questions over who can have such powers, no more of the complex drafting of powers of withdrawal, no more conceptual complexities of lapses and hanging powers and, overall, it seems, no more trying to keep track of it all. Such benefits may well be sufficient to convert many.

B. Major Disadvantages of Code Sec. 2503(c) Trusts

The major sources of drafting complications are the statute's own limitations. First, the vast majority of children will live well beyond age 21 and the vast majority of parents making gifts to children under age 21 will wish to continue to make gifts after their children have reached that age. Some mechanism must therefore be provided to permit gifts made when the donee is no longer under age 21 to qualify as "present interests." It seems Crummey powers contingent on the age of a donee at the time of the gift would be required, making all of the other simplifications only a temporary reprieve, not an actual simplification.

Second, gifts in excess of the annual exclusion amounts will not qualify as "present interests" under Code Sec. 2503(c) . Provision must therefore be made to treat gifts in excess of the annual exclusion amounts differently from those that are within the annual exclusion amounts.

Third, gifts qualifying for the gift tax annual exclusion under Code Sec. 2503(c) are required to be payable to the beneficiary's estate or subject to a general power of appointment held by the beneficiary at his death. This means that the trust property will be included in the donee's estate at his or her death. Generation skipping tax planning beyond that donee will therefore not be feasible under such a trust.

This difficulty fosters two separate complexities, one from a drafting point of view and the other from a reporting point of view. From a drafting point of view, alternative dispositive provisions may be desirable for gifts not qualifying under Code Sec. 2503(c) since they need *not* be included in the donee's estate, for estate tax and generation skipping tax purposes. For reporting these gifts on the gift tax returns, gifts qualifying under Code Sec. 2503(c) will likely also qualify for the non-taxable gift exclusion from the generation skipping tax under Code Sec. 2642(c) . One must therefore be careful *not* to waste generation skipping tax exemption on these gifts (to the extent that such gifts are to skip persons and are therefore direct skips). This distinction spawns its own drafting complexities since the alternative provisions covering gifts that do not qualify under Code Sec. 2503(c) should be crafted so as to permit GST exemption to be immediately applied to those gifts, to the extent desirable. To implement this split generation skipping tax reporting, it seems that the trust will have to divide into Code Sec. 2503(c) and non- Code Sec. 2503(c) shares and trusts at the outset. [33]

Drafting Suggestions

A. Will There Be Gifts To This Beneficiary After the Beneficiary Is Age 21? This is the single most important question that must be asked in considering the use of a Code Sec. 2503(c) trust. If gifts after the minor has reached majority are a foreseeable part of the plan, there are only two realistic choices:

- Create two complete sets of dispositive provisions under a single trust instrument, one to make contributions during the minor's minority qualify for the annual exclusion under Code Sec. 2503(c) with the requisite provisions for such a trust, and another to qualify gifts to the beneficiary when he or she is no longer a minor, with the provisions permitted for such a trust. By far the vast majority of children will live beyond age 21 and the vast majority of parents making gifts to children under age 21 will wish to continue to make gifts after their children have reached that age. The trust must therefore separate gifts made when the donee is under age 21 from those made thereafter in order to (1) qualify those gifts made after minority as "present interests" using some other mechanism, and (2) qualify gifts made during the beneficiary's minority for treatment under Code Sec. 2503(c) .
- Use two completely separate trusts for each beneficiary, drafting only the Code Sec. 2503(c) trust now. In the author's experience, this seems to be the preferable course. First, no compliance with the generation skipping separate share rule of Reg. § 26.2654-1(a) is required and therefore no overfunding of the Code Sec. 2503(c) trust is required in order to fund the non- Code Sec. 2503(c) trust "from and at all times after the creation of the trust." [34] Second, two separate trusts will optimize drafting simplifications since coordination of the various dispositive and administrative provisions will be achieved by selecting the appropriate trust to put the gift into, not by complicated legal language. Third, if only annual exclusion amounts are contemplated at this time, the trust for amounts in excess of the annual exclusion or for gifts made after the beneficiary has reached age 21 will be based on the law in effect at that time, not on the law at this time. Since funding will likely invoke the law at that time, this is likely to be beneficial since the annual exclusion may then have increased. [35]

But assume we want a single trust instrument, e.g., to receive a contribution in excess of annual exclusion amounts. How different will the underlying dispositive schemes have to be? As indicated below, virtually everything will have to be different.

The Minor's Trust

The trust for gifts during minority:

(A) Will not have any beneficiaries other than the minor beneficiary for whom created because a trust with multiple beneficiaries would violate both the passing requirement and the contingent payment requirement under Code Sec. 2503(c)(2)(A) and Code Sec. 2503(c)(2)(B) .

(B) Will not have an ascertainable standard for distributions (since an ascertainable standard will violate the benefit requirement by being too restrictive) and will use "benefit" as the standard for distribution instead.

(C) Will not use allocations of generation-skipping tax exemption but will be exempted from the generation skipping tax as a non-taxable gift under Code Sec. 2642(c) . Since the trust will be included in the donee's gross estate, the utility of this trust for generation skipping tax purposes beyond the donee is limited.

(D) Will not have annual withdrawal powers but will automatically qualify as a present and not a future interest for gift tax annual exclusion purposes.

(E) Will have a one-time only withdrawal power over either the entire trust or the entire amount of accumulated and unspent trust income, as the case may be, at age 21. This power is required in order to qualify the trust under the passing requirement without paying the entire trust over to the minor at age 21. This power will cause this trust (or the entire accumulated and unspent income) to be includable in the beneficiary's gross estate for estate tax purposes *to the extent that the lapses exceed the limitations of the "five and five" rules under Code Sec. 2041(b)* . See "Hanging the Age 21 Withdrawal Power," below.

(F) Will not be able to accommodate gifts in excess of the annual exclusion amounts without incurring the costs applicable to gifts intended to qualify for the annual exclusion under Code Sec. 2503(c) since the trust is required to contain provisions complying with the requirements of Code Sec. 2503(c) . For example, a gift of $11,000 would all have to be subject to the withdrawal power at age 21 under the terms of this trust even though only $10,000 of the $11,000 gift qualifies for the exclusion.

(G) Attempts to qualify gifts to more remote generations than are currently made donees under the trust for the automatic benefits of 2503(c) trusts will be difficult to draft and will require pre- and post- 21 provisions as well.

(H) Will not be concerned with compliance with the estate tax inclusion period rules in structuring the trust since gifts to the trust will qualify for the non-taxable gift exclusion under Code Sec. 2642(c) .

The Over Age 21 or In Excess of Annual Exclusions Trust

(A) Will have more than one beneficiary even if distributions to only one beneficiary are contemplated if, for no other reason, than to optimize protections from the beneficiary's creditors.

(B) Will use an ascertainable standard in order to permit the beneficiary to be or become his or her own trustee without forfeiting creditor protections and without having the trust automatically included in the beneficiary's estate.

(C) Will use allocations of generation-skipping tax exemption to remove the entire trust from generation skipping tax forever because gifts to this trust will not qualify for the non-taxable gift exclusion under Code Sec. 2642(c) .

(D) Will use annual withdrawal powers to qualify each contribution (rather than the entire trust or the entire accumulated income) for the annual exclusion from gift tax, since, otherwise, gifts to this trust would not qualify as present interests under Code Sec. 2503(b) .

(E) May be subject to either estate tax or generation skipping tax at the beneficiary's death, but this choice may be made much later down the road by giving an independent trustee the right to grant the beneficiary a general power of appointment and need not be made in favor of estate tax inclusion now as under the minor's trust.

(F) Will be able to accept gifts in excess of the annual exclusion amounts without subjecting them to withdrawal powers since the withdrawal power sections simply will not apply to the excess amounts under the applicable formulas in the trust.

(G) Attempts to qualify additional contributions to the Crummey trust will not pose significant drafting difficulties beyond those inherent in drafting Crummey trusts, since the formulas in those powers will be self-defining.

(H) This trust will have to comply with the estate tax inclusion period rules so that allocations of GST exemption can be effective immediately.

For generation skipping tax purposes, the single trust will have to direct that gifts received be divided into separate shares on receipt depending on whether they are within or without the annual exclusion amounts and whether they are made during the donee's minority or not.[36] Indeed, given the language of the Regulation, it is probably necessary to intentionally overfund the annual exclusion gift at the outset in order to create both the annual exclusion share and the excess share "at all times from and after the creation of the trust."[37].

B. Will There Be Gifts to This Beneficiary In Excess of the Annual Exclusion Amounts? This is the second most important question and, if there will be gifts in excess of the annual exclusion amounts, results in the same difficulties as are set forth above in the case where gifts will be made to the beneficiary after the beneficiary reaches majority.

Hanging The Age 21 Withdrawal Power[38]

An interesting possibility is terminating the beneficiary's power of withdrawal at age 21 (the "age 21 power") under a hanging power mechanism. For many clients who are anxious about the children exercising this power in the first place, extending the time period during which that power can be exercised may not be acceptable. But there are also clients whose children are very willing to abide by their parents' wishes.[39]

For those clients, consider the effects of terminating the withdrawal power at age 21 with a hanging mechanism, that is to say, over time and within the limitations of Code Sec. 2514(e) ("five and five lapses"). Over time, such lapses could have the effect of removing the property subject to the power from the beneficiary's gross estate. The "transfer" predicate for includability as a transfer with a retained life estate under Code Sec. 2036 and for includabilty as a transfer with a retained reversion would be removed to the extent of the "five and five" lapses.

The five and five lapses would have to be completed gifts, however. This means that the beneficiary could *not* retain a testamentary power of appointment over those amounts as to which the power of appointment had lapsed under the five and five exception.[40] It would therefore be necessary to draft the beneficiary's testamentary power of appointment to exclude sums over which the beneficiary's age 21 power had lapsed.

Moreover, it will take substantial periods of time to fully dissipate the power. Assuming that the trustee realizes an 8% gross return and receives gifts equal to the annual exclusion amounts from a married couple for 21 years, the fund will grow to $879,702. If the power is reduced by the greater of $5,000 or 5% of total assets and the same growth continues after age 21 (assuming the highest marginal income tax rate throughout), it will take upwards of thirteen years to reduce property subject to the the power to zero.

Nonetheless, terminating the age 21 power under a hanging mechanism could have the desired effect of removing the property from the beneficiary's taxable estate and, if generation-skipping is not being used anywhere else in the plan, or if exemption is otherwise available, this plan might also avoid that tax.

Otherwise, problems arise, however, with the application of the generation skipping tax under a power terminating under the five and five limits. First, without more, the trust will not qualify for the non-taxable gift exclusion under Code Sec. 2642(c)(2)(B) since that section requires that "if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of the individual." Code Sec. 2503(c) only requires this result during the beneficiary's minority, but Code Sec. 2642(c) requires that result at any time during the beneficiary's life. And the trust provisions will not so require if the power lapses under five and five limits.

Another point under the generation-skipping tax is that to the extent the "five and five" lapses are not effective, the transferor will change, [41] perhaps undoing generation skipping tax exposure to the extent that the power lapses subject to tax. However, the transferor will not change to the extent that the five and five lapses have taken place. And to that extent, there will likely be a generation skipping tax at the beneficiary's death.

One approach to the generation skipping tax problem is to have the grantor allocate exemption to the trust annually, putting the Code Sec. 2503(c) trust on a par with Crummey trusts on this score. But this will have the effect of undoing the simplicity of automatic qualification for both the gift tax annual exclusion and the generation skipping tax's non-taxable gift exemption.

A creative possibility is that the trust could direct that amounts as to which the beneficiary's age 21 power has lapsed under the "five and five" provisions are to be put into a trust for the beneficiary's spouse. The spouse is assigned to the same generation as the person to whom the spouse is married [42] and would clearly not be a skip person if the beneficiary were not a skip person. If the spouse had a general power of appointment under the trust, [43] then the beneficiary's spouse would become the transferor [44] and the spouse could then apply his or her own generation skipping tax exemption to the trust amounts as to which the beneficiary's age 21 had power had lapsed under the "five and five"exception. At the death of the beneficiary's spouse, the trust property would pass to his or her descendants exempt from generation skipping tax, but subject to estate tax in the beneficiary's spouse's estate. The effect could well be to utilize exemptions, exclusions and credits that would otherwise go unused.

Circumstances in Which 2503(c) Trusts May Be Useful

It seems that there are two principal circumstances in which Code Sec. 2503(c) trusts may be useful, given all the difficulties.

A. Modest Gifting. The first involves families of limited means in which some modest gifts (usually not even up to, no less in excess of, the annual exclusion amounts) may be made to children by parents or grandparents who have limited relatively financial resources. In this circumstance, the automatic exclusions and exemptions provided by Code Sec. 2503(c) trusts may be welcome and useful.

B. The Code Sec. 2503(c) Income Only Trust. The other circumstance in which Code Sec. 2503(c) trusts may be useful is at the opposite end of the wealth spectrum. It is settled that Code Sec. 2503(c) may be applicable either to trust principal and income interests or to the income interest alone. [45] By applying Code Sec. 2503(c) to the income interest alone at or near the time of birth of each grandchild, a donor can achieve a present interest for a very significant portion of the property transferred to the trust.

For example, a donor could give $26,049.30 to a trust for a newly born minor, qualifying the income interest for treatment under Code Sec. 2503(c) . At a time when the Code Sec. 7520 rate is 7.2% (October, 1999, Rev Rul 99-41), that would result in $20,000 (76.775%) being treated as a present interest and only $6,049.30 being treated as a taxable gift. At 8% compounded annually for 21 years after tax, the result of that one gift would be about $131,126 at age 21 (about 5 to 1), at 10%, about $192,769 (about 7.4 to 1), and at 12%, about $281,429 (about 10.8 to 1).

The donee's power to withdraw at age 21 will be limited to the then-current and accumulated income. That amount can be largely controlled by trust investment policy. Investments in non-dividend paying securities or raw land could be favored by the trustees, with the result that most of the growth would be included in principal as capital gain.

Using this approach, trust dispositive provisions could provide for discretionary payments for benefit, extended perhaps to both income and principal after age 21. This approach optimizes creditor protections and could result in the exclusion of trust principal from the donee's gross estate so long as an independent trustee is used from the outset.

A competing approach would use trust dispositive provisions requiring the payment of all income annually and would not use Code Sec. 2503(c) . The present interest created by such a trust (the immediate income interest) would be greater than 98%, but payments of income would be required to be made at least annually, exposing those payments to claims of creditors. When actually paid out, those payments might become commingled with marital property, resulting in exposure to equitable distribution as well as to commercial creditors.

In short, using Code Sec. 2503(c) on the income alone allows greater creditor protections to be enabled, but results in a smaller amount of the trust qualifying for the annual exclusion than would be the case if income were required to be paid annually to the beneficiary for life. [46]

Income Tax Issues

The income tax status of the trust is another issue that should be considered in designing and drafting the Code Sec. 2503(c) trust. The trust itself could be the income tax paying entity, but then the income tax on trust income will be determined under the compressed rate structure applicable to trusts and estates. [47]

Alternatively, the trust could be structured to be a grantor trust as to the settlor. [48] Under this design, the income tax applicable to trust income will be determined under the rate structure applicable to individuals. [49] Moreover, that tax will be payable by the grantor, and not by the trust. [50] This tax payment is not an additional gift since it will discharge the grantor's legal obligation to pay the tax. [51] However, the effect will be to substantially enhance the accumulation of income and capital gains in the trust.

For example, $100,000 growing at 6.04% net after income tax annually for 20 years becomes $323,143. However, if that same income were free of the maximum federal income tax of 39.6%, it would be the equivalent of a 10% annual return and would become $672,750. In other words, making the income free of the burden of federal income taxes increases the compounded growth of that income by 108.18%. Assuming all growth was capital gain, the same sum would grow at an effective 8% rate of growth after capital gains tax and would become $466,096 as compared to the $672,750 under tax free compounding.

Making the trust a grantor trust may also facilitate funding the trust with S corporation stock. If a Code Sec. 2503(c) trust is funded with S corporation stock, the trust will qualify as a qualified subchapter S trust (a "QSST"), if all of the income is in fact distributed to the beneficiary annually. [52] A Code Sec. 2503(c) trust could also qualify as an eligible shareholder of an S corporation if an election is made to be treated as an electing small business trust (an "ESBT"), but then all S income will be taxed at the highest marginal rates. [53] If a Code Sec. 2503(c) Trust is a grantor trust as to the settlor, it will qualify as an eligible shareholder of an S corporation without distributing all of its income to the beneficiary annually and without electing to have all of its income taxed at the highest marginal income tax rates. [54] In addition, of course, that tax will be payable by the settlor, rather than by the trust making the S income effectively free of all income taxation to the beneficiary.

While treatment as a grantor trust is generally advantageous from a transfer tax perspective, some grantors may not want the burden of the continued income taxation. This burden can be particularly heavy when a sale of the S corporation stock or other trust assets takes place and it is the capital gain taxes that must be paid by the settlor. It is important to take these possibilities into account in determining whether or not to make the Code Sec. 2503(c) trust a grantor trust.

Conclusions

The Code Sec. 2503(c) trust is beneficial but limited in usefulness. Hopes for simpler drafting seem misplaced unless gifts are definitely limited to the annual exclusion amounts and are definitely going to cease once the minor becomes age 21. Those circumstances are likely to be unusual. Simpler administration can be accomplished for gifts up to annual exclusion amounts during minority, but gifts of greater amounts and gifts made after minority will not be appropriate to make to this trust. For gifts in excess of the annual exclusion amounts or at times when the beneficiary is not a minor, either complex coordinating provisions or a separate trust are needed.

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[1] Code Sec. 2503(b) . The purpose of the exclusion is "....to obviate the necessity of keeping an account of and reporting numerous small gifts... to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts..." S. Rep. NO 665, 72nd Cong., 1st Sess. (1932), reproduced in 1939-1 C.B. 496 at 525.

[2] The amount of the exclusion historically is calculated on per donee basis and began at $5,000 in 1932. It was decreased in 1939 to $4,000 and again to $3,000 in 1943 where it remained until 1981 when the amount of the exclusion was increased to $10,000. In 1997, Congress enacted legislation to adjust the exclusion amount for

inflation effective for years after 1998, but in $1,000 increments. The result is that compounded inflation of less then 10% will not result in an increase in the amount of the exclusion. Therefore, there will be no increase in the exclusion amount until the year 2000 at the earliest. The Senate has recently proposed increasing the exclusion. See S. 1429, Sec 721 (106th Congress) and S. Rep. at 106-120 at 98, et seq. (increase to $12,000 for 2001, to $13,500 for 2002, to $15,000 for 2003, to $16,500 for 2004, to $18,000 for 2005 and to $20,000 per donee per year for 2006 and beyond).

[3] Code Sec. 2503(b) . All section references are to the Internal Revenue Code of 1986 as amended.

[4] A gift to a trust is a gift to the beneficiaries of the trust and not a gift to the trustee. Helvering v. Hutchinson, 312 U.S. 393 (1941); Reg. § 25.2503-2 .

[5] Fondren v. Comm'r, 324 U.S. 18 (1945) and Reg. § 25.2503-3(b) (as to income interests); Crummey v. Comm'r, 397 F. 2d 82 (9th Cir, 1968) and Reg. § 25.2503-3(b)) (as to property subject to a presently exercisable power of appointment).

[6] See, e.g., Kieckhefer v. Comm'r, 397 F. 2d 118 (7th Cir. 1951) ; Fleming, "Gifts for the Benefit of Minors," 49 Mich. L. Rev. 529 (1951).

[7] *Fondren,* note 5, supra.

[8] *Fondren,* note 5, supra at 20.

[9] See, e.g., *Kieckhefer v. Comm'r,*supra, note 6.

[10] Custodianships under the Uniform Gifts To Minors Acts had not come into existence yet. And those custodianships qualify as non-future interests under Code Sec. 2503(c) [Rev Rul 56-86 , Rev Rul 1956-1 C.B. 449; Rev Rul 59-357 , Rev Rul 1959-2 C.B. 212]. Code Sec. 2503(c) was also not yet in existence.

[11] Rev Rul 54-400 , Rev Rul 1954-2 C.B. 319 , holds that outright gifts to a minor are not future interests and qualify for the annual exclusion.

[12] Reg. § 25.2503-4(b)(1) .

[13] 348 F. 2d 577 (5th Cir. 1965).

[14] 1969-1 C.B. 226.

[15] 1967-2 C.B. 349.

[16] 55 TC 746 (1955), acq. 1974-1 CB 2. To the same effect, see Craig v. Comm'r, 30 TCM 1098 (1971).

[17] 378 F.2d 693 (Ct. Cl. 1967).

[18] But see Mueller v. United States, 69-1 USTC Para 12,592 (WD Mo., 1969) (permitting the annual exclusion under Section 2503(c) for a trust paying as trustee "deems necessary for said child's support, health and education"); compare *Nat'lL Bank of Springfield, infra, note 20.*

[19] Reg. § 25.2503-4(b)(1) .

[20] 756 F. Supp. 1117 (CD ILL. 1991).

[21] See Reg. § 25.2503-4(b)(1) .

[22] Supra, note 14.

[23] Rev Rul 68-670 , Rev Rul 1968-2 CB 413.

[24] 1959-2 C.B. 212.

[25] This ruling and Rev Rul 56-86 , Rev Rul 1956-1 CB 449 , held that gifts to custodianships under the Uniform Gifts To Minors Acts qualify as gifts of a present interest because such custodianships meet the requirements of Code Sec. 2503(c)

[26] 1974-1 CB 285.

[27] 1960-1 CB 378, superseding Rev Rul 59-144, 1959-1 CB 249

[28] PLR 8434071 (May 23, 1984) held that 90 days was reasonable.

[29] The property subject to the power of appointment will be included in the beneficiary's taxable estate whenever he or she dies under Code Sec. 2041 as property that has been subject to a general power of appointment that has lapsed unless the lapses fall within the "five and five" exceptions under Code Sec. 2041(b) . as to which see text accompanying note 38, infra. Depending on the terms of the continued trust, the property may also be includable under Code Sec. 2036 as property transferred with a retained right to beneficial enjoyment or under Code Sec. 2037 as property transferred with a retained reversionary interest. If

none of the retained powers provisions apply, there may be a completed gift on the lapse of the power to the alternate takers under the trust instrument. See generally Code Sec. 2514 , Rev Rul 86-39, 1986-1 CB 301 , Rev Rul 76-547, 1976-2 CB 302 , and Rev Rul 79-421, 1979-2 CB 347 .

[30] See generally, P. Spero, Asset Protection: Legal Planning and Strategies ¶4.04 [1] (1994).

[31] Multiple beneficiaries of a single trust would also violate the contingent payment requirement since there could be no assurance that the property would be payable to his or her estate or subject to a general power of appointment at his or her death prior to attaining age 21 since the property might instead have been paid in whole or in part to one of the other beneficiaries.

[32] See generally PLR 8507017 and PLR 8512048 .

[33] See Reg. § 26.2654-1(a)(1)(i) . Indeed, the way the Regulation is phrased, it is probably necessary to intentionally overfund so as to create the share in excess of the Section 2503(c) share immediately in order to comply with the requirement that that share exist "at all times from and after the creation of the trust." See Reg. § 26.2654-1(a)(5) , Example 8.

[34] See note 33, supra.

[35] See note 2, supra.

[36] Reg. § 26.2654-1(a)(1)(i) , note 33, supra.

[37] Id.

[38] Powers of appointment are taxable if "exercised or released...." Code Sec. 2514(a) and Code Sec. 2041(b)(2) . Code Sec. 2514(e)(1) , Code Sec. 2514(e)(2) and Code Sec. 2041(b)(2)(A) and Code Sec. 2041(b)(2)(B) exclude lapses of powers of appointment from the definition of release "only to the extent that" those lapses exceed the greater of $5,000 or five percent of the assets out of which such power may be satisfied.

[39] See, e.g.,Estate of Kohlsaat v. Comm'r, TC Memo 1997-212 (1997)

[40] Reg. § 25.2511-2(b) .

[41] Reg. § 26.2652-1(a)(5) (Example 5); see also C. Harrington, L. Plaine and H. Zaritsky, "Generation Skipping Transfer Tax: Analysis With Forms," 5.02[5][c] (1996).

[42] Code Sec. 2651(c)(2)

[43] The trust could provide the spouse with a power to appoint trust income and principal to the creditors of his or her estate, for example. Code Sec. 2041(b)(1) .

[44] Code Sec. 2652(a)(1)(A) .

[45] See note 23, supra, and accompanying text.

[46] An attempt to combine a Code Sec. 2503(c) trust relating to income with a mandatory annual income payment for life beginning at age 21 was rejected in Estate of Levine v. Comm'r, 526 F. 2d 717, 76-1 USTC Paragraph 13,115 (2d Cir. 1975).

[47] See Code Sec. 1(e) . The maximum capital gains tax rates under the individual tax rate structure is applicable to gains and losses realized by the trust.

[48] Discussion of the techniques by which trusts not otherwise treated as grantor trusts under Subpart E of Subchapter J of the Internal Revenue Code may be made into a trust which is so treated is beyond the scope of this article. Of the many fine discussions of this matter, see especially T. Calleton and S. Trytten, "Grantor Trusts," 18th Annual CEB-UCLA Estate Planning Institute (1996); Roth, "The Intentional Use of Tax Defective Trusts," 26 U. Miami Est. Planning Inst. ch. 4 (1992); H. Zaritsky and S. Leimberg, "Tax Planning With Life Insurance," Paragraph 5.03[3].

[49] Code Sec. 671 , et seq.

[50] For ruling purposes, the IRS for a while required that grantor trusts provide that the grantor would be reimbursed from trust assets for the income tax paid. In PLR 9444033 , the Service stated that the payment by the grantor of the income tax would be an additional gift. In response to a clamor of protest, the IRS reissued the ruling, striking the statement that such tax payment would constitute an additional gift. Compare PLR 9444033 (8/5/1994) reissued as PLR 9543049 (10/27/1995) ("Finally, after reconsidering the language addressing the gift tax consequences of the reimbursement clause in each trust, the Service has decided to delete the second full paragraph on page 6 of the ruling.").

[51] See note 50, supra.

[52] The requirements to qualify as a "qualified subchapter S trust" or "QSST" are set forth in Code Sec. 1361(d)(3)

and are not identical to the requirements for a Code Sec. 2503(c) trust, although there are some similarities. First, while a Code Sec. 2503(c) trust requires a single beneficiary during the minor beneficiary's minority, a QSST must require only a single income beneficiary "during the life of the current income beneficiary." Code Sec. 1361(d)(3)(A)(i) . This means that the trust after the beneficiary's minority cannot have multiple beneficiaries if the trust is going to qualify as am eligible shareholder of an S corporation by being a QSST. The corpus requirement of Code Sec. 1361(d)(3)(A)(ii) , that corpus can only be paid to the income beneficiary, is similar to the requirement of Code Sec. 2503(c) that corpus only be payable to the minor beneficiary, but again that restriction is extended from minority throughout the beneficiary's lifetime. The requirement that the income interest can only terminate on the beneficiary's death or on termination of the trust is an additional requirement over and above those set forth in Code Sec. 2503(c) since it also extends beyond the minor's lifetime. The requirements of Code Sec. 1361(d)(3)(A)(iv) that the trust distribute all assets to the beneficiary on termination seem similar to Code Sec. 2503(c) 's Passing and Contingent Payment requirements (see text accompanying nn. 24-32, supra), but again extends beyond minority. The requirement of Code Sec. 1361(d)(3)(B) that all income be distributed annually might be seen as a "substantial restriction" on the trustee's discretion to apply income and principal for benefit, disqualifying the QSST as a Code Sec. 2503(c) trust. However, since Code Sec. 2503(c) only sets forth the maximum restrictions (Rev Rul 59-357 , n. 24, supra), the annual distribution of all income to the minor would probably be considered a harmless early termination of the Code Sec. 2503(c) trust as to that income and therefore would not disqualify the Code Sec. 2503(c) trust. The point for this discussion is that avoiding these restrictions by qualifying the trust as an eligible S shareholder on the grounds that it is a grantor trust as to the settlor is clearly preferable.

[53] The requirements for being treated as an electing small business trust ("ESBT") are set forth in Code Sec. 1361(e) and include the limitation that beneficiaries include only individuals, estates and certain charities. While these are similar to the requirements for being an S shareholder generally, clearly the maximum marginal tax rate imposed on ESBT's by Section 641(c)(1)(b) is clearly worth avoiding by qualifying as an eligible S shareholder on the grounds of being a grantor trust as to the settlor instead. .

[54] See Code Sec. 1361(c)(2)(A)(i)