Legal Matters®

Estate Planning
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How to give assets to your grandchildren (but keep control)

Many older people would like to make significant gifts to their grandchildren, in order to help them and in order to reduce the size of their own estate for tax purposes. But they also worry that the grandchildren won't be able to handle large sums of money.

The good news is that you can give each of your grandchildren up to $13,000 a year without incurring any gift tax. If you're married, your spouse can also give each grandchild up to $13,000 a year.

The bad news is that young people are notoriously immature with money, and simply handing a young adult up to $26,000 a year won't necessarily result in the wisest and most cautious financial decisions.

However, there are ways that you can "give" money to grandchildren for tax purposes, but retain control over it at the same time.

If your grandchildren are minors, then you can't transfer assets to them directly. In most cases, you'd need to transfer assets to a custodial account, where an adult custodian manages the account for the child's benefit.

That's great – but the problem with a custodial account is that the moment the minor reaches adulthood (usually at age 18 or 21), he or she will own the account completely. The brand-new adult can immediately withdraw all the money and spend it on anything he or she feels like.

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A better solution is to put the money into a trust. With a trust, you can specify that your grandchildren won't have access to the assets until they are old enough to handle them responsibly. For instance, a trust might end when a grandchild turns 28. Or a grandchild might get a third of the assets at age 25, a third at 30, and the rest at 35.

Setting up a trust for a grandchild is a little tricky, though. While

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you (and your spouse) can directly give an adult grandchild $13,000 a year without paying gift tax, the same rule doesn't apply if you put the money in a trust.

That's because you're not really "giving" the grandchild the money; you're just giving him or her a future interest in the money. The law says that to avoid the gift tax, you have to give a "present interest" in the money.

With a trust, you can specify that your grandchildren won't have access to the assets until they are old enough to handle them responsibly.

So here's the solution: The trust is set up so that whenever you make a contribution, the grandchild has the right to withdraw that contribution for the next 30 days. If the grandchild does nothing, the money stays in the trust and the grandchild can no longer access it directly. But the contribution still counts as a "gift" for tax purposes.

Of course, this creates the risk that the grandchild will withdraw the money during the 30 days. How-ever, you can make it clear to the grandchild that if he or she does so, you won't make any more contributions – which should be a very strong deterrent.

This type of trust is known as a "Crummey" trust. Despite the funny name, there's nothing wrong with a Crummey trust. It was named for D. Clifford Crummey, the man who pioneered the idea back in the 1960s.

To make things easier, a single Crummey trust can be created to benefit multiple grandchildren.

Here are a few things to consider if you're contemplating a Crummey trust:

- You can be the trustee if you want. But if you (or your spouse) is the trustee, you'll need to be careful in the way the trust is set up and administered, because if it's not done properly, the assets in the trust may be included in your taxable estate if you pass away.
- You'll want to decide who should pay the tax on the trust's income. You can set up the trust such that the income will be taxable to the trust, to the grandchild, or to you.
- The trust's assets will typically be considered as assets of the grandchild for purposes of calculating college financial aid awards.
- Any time you make gifts to grandchildren, you need to plan around something called the "generation-skipping transfer tax." This is a special tax designed to prevent people from avoiding gift and estate taxes by making gifts that skip generations. You may be able to plan around it and avoid it – depending on your circumstances – but you'll need to take it into account.

Do your tax homework if you're converting to a Roth IRA

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A lot of people are converting their regular IRA or old 401(k) plan into a Roth IRA in 2010. That's because Congress lifted a number of restrictions on these conversions this year. It also gave people who convert in 2010 a special one-time benefit: Rather than reporting the resulting income on their 2010 tax return, they can choose to report nothing for 2010, and then report half the income on their 2011 return and half on their 2012 return.

However, you might be better off recognizing all the income in 2010. To decide, you'll need to do some tax homework.

In general, with a Roth IRA there's no tax deduction for contributions, but withdrawals are tax-free. Depending on your circumstances, Roth IRAs can be better for estate planning, because:

- There are no required minimum distributions during your lifetime. So if you don't need the IRA funds to live on, you can leave the entire IRA to your heirs without having it diminished each year.
- Your heirs won't have to pay income tax (federal or state) on their withdrawals.
- If tax rates go up (which seems likely), you'll save because you can contribute after-tax dollars at today's rates, and won't have to pay taxes on withdrawals at a higher rate in the future.

On the other hand, if you convert an existing account to a Roth, the amount you move to the Roth

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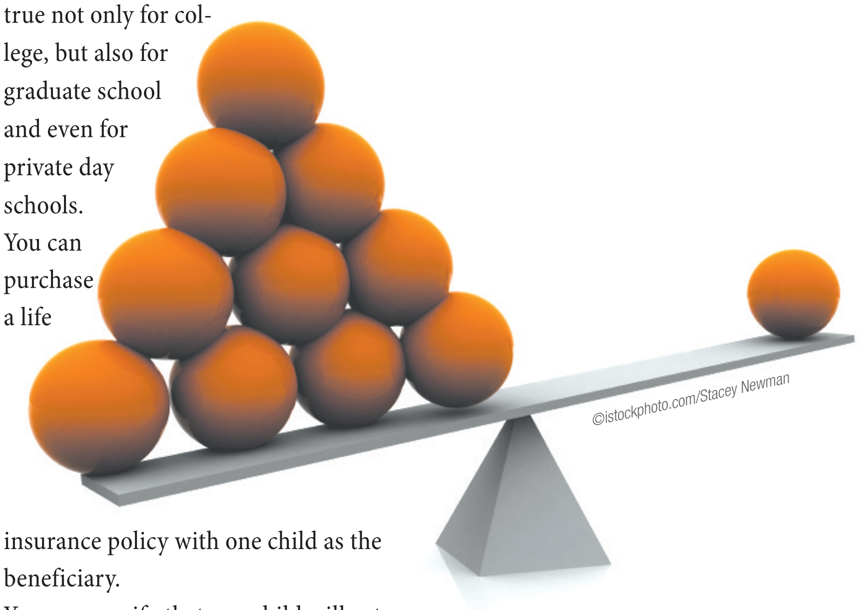
What if you want to give one child more than another?

There are many reasons you might want to leave more assets to one child than to another in your will. One child might have a greater need, or have been more loyal over the years, or have gone out of his or her way to be a caretaker.

Of course, you can simply leave your children different amounts in your will. But doing so is a dramatic statement and can often lead to jealousy and resentment within the family. Keep in mind that it's usually possible to leave your children equal amounts in your will, but still favor a particular child in other, more subtle ways. For instance:

- You can quietly make lifetime gifts to one child but not others. Currently, you can give a child up to $13,000 a year without triggering gift tax consequences. You can also give $13,000 to the child's spouse and to each grandchild.
- You can also help a child by paying your grandchildren's tuition. As long as you pay the school directly and don't give the money to your child, you can contribute as much as you want without triggering the gift tax – and you can still make $13,000 gifts each year to your child and to his or her family members. This is true not only for college, but also for graduate school and even for private day schools.
- You can purchase a life insurance policy with one child as the beneficiary.
- You can specify that one child will get certain valuable items of personal property (such as jewelry) to which they have a sentimental attachment.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Some parents are reluctant to leave money to a child because they fear it could be lost to an addiction, a greedy spouse, or a creditor. In such cases, you can often protect a gift to a child by putting the money into a trust that will last for the child's lifetime.

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is considered taxable income to you, and you have to pay income tax on it.

If you're thinking of converting in 2010 – or if you've already converted – you'll have to decide whether to take advantage of Congress's offer to spread the resulting taxable income over 2011 and 2012.

Ordinarily, it's always better to pay taxes later rather than sooner, and to spread taxable income out over multiple years. But in certain circumstances, it might be better to recognize the income in 2010. For instance:

- Many tax deductions and credits phase out if you have a certain level of income. A big spike in taxable income could deprive you of these benefits. You might be better off recognizing all the income in 2010 and losing this advantage in only one year rather than two.
- A higher level of income can result in Social Security benefits being taxed, and can raise Medicare Part B premiums. Again, you might want to have this happen in only one year rather than two.
- If your child is applying for college financial aid, you should be aware that most colleges don't consider money in retirement accounts when calculating an award of aid, but they do consider income. This could factor into choosing which year or years you want to report a spike in your taxable income.
- If you think tax rates will go up in 2011 and 2012 for high earners, you might want to recognize the income in 2010 and pay taxes at the 2010 rates.

Consider making large gifts before the end of 2010

It's not for everyone, but certain people can save a lot of taxes by making large gifts to family members or others before the end of 2010, and paying a gift tax on the transfer.

In general, you can give up to $13,000 to as many people as you like each year without having to pay gift tax. Also, you can give up to $1 million above that limit over the course of your lifetime, and defer the tax. You won't have to pay gift tax now, but the amount of the gift will reduce the credit that can be taken against estate taxes when you die.

Once you've used up the $1 million, any further gifts result in a gift tax bill that's due right away.

Why should some people make large gifts now and pay the tax? Because for the rest of 2010, the gift tax rate is "only" 35%. After the year ends, the gift and estate tax rate shoots up to 55% (unless Congress changes the law, which is possible).

So by making gifts and paying the tax now, you may be able to get a much better tax rate than if you make gifts later, or make bequests in your will.

You should consider, though, that if you make a gift and die within three years, the advantage of this tax break is reduced because the amount of tax you paid will be considered part of your estate for tax purposes. Your family won't be any worse off tax-wise as a result of the gift, but this is still something to consider.

Please feel free to call if you would like advice on how this idea applies to your specific situation.

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