A Gift in Trust that Keeps on Giving

12 Reasons to Make Major Gifts in Trust and Not Direct.

Suppose you wish to make gifts to your children, siblings, or parents. The best arguments for using a trust vs. making direct gifts are:

1. Privacy. The gift to a Gift Trust is in a protected envelope that no one knows the contents of besides the sibling and anyone he/she shares the info with. Direct gifts will be obvious to all who can see the contents of the bank account.

2. Protection. The contents of the Gift Trust are for the use of the named beneficiaries only, not any interlopers. Meddling or divorcing spouses or creditors cannot reach the Gift Trust contents. Direct gifts are susceptible to the claims of others because they are owned by the donees and therefore vulnerable to being taken from them. You can put in a person besides the beneficiary as the trustee for further privacy and protection, or control if you wish. Even your spouse can be the trustee (if that gives you control...).

3. Spendthrift avoidance. The contents are sheltered from the beneficiary’s own misspending (if you want it to be) but putting in standards for use, like health, education, maintenance, and support. There is no such protection for a direct gift.

4. Financial disclosure. While assets can be withdrawn from the Gift Trust for the beneficiaries, they do not have to be, and certainly not all at once. Inside the Gift Trust, they are not counted as assets for purposes of financial aid applications (provided in my experience that someone besides the parent of the child applying for financial aid is not the trustee). Obviously there is no such shelter with a direct gift. The same can be true for the other end of the donee-age spectrum. Assets in a trust set up by someone else (except one spouse for another) are not countable as having to be spent down in many jurisdictions before qualifying for Medicaid to pay for a nursing home, for example.

5. Flexible use of a note. Say you seed the gift with a major gift and take back a promissory note with interest. There will be no tax consequence to you for the interest on the note(s) as the Gift Trusts (your alter ego for tax purposes) are paying you. There is no tax on income you pay yourself in this context. Forgiving the interest and principal each year can easily be tracked with a spreadsheet.

This is a stronger advantage than you might think. Loans direct to family MUST bear interest, according to the IRS with some exceptions. Forgiving the interest does not obviate the need to report it and pay taxes on it.
6. A stable donee and “debtor”. Trust beneficiaries are predictable and stable even if the primary beneficiary/sibling dies, or disappears (ok, that’s probably unlikely) because you will have named alternate beneficiaries. If the Gift Trust signs a promissory note, then the balance due can continue to be forgiven toward the remaining beneficiaries.

7. Leverage of the annual gift exclusion.

A gift to a trust can employ multiple generations of donees as recipients of the annual gifting.

- E.g., a family has 1 head and 3 children. The head (a sibling presumably) can receive the entire Gift Trust contents as you see fit to set up the trust (and the sibling can share it with his/her spouse and children) but the sibling has control (or a trust for a sibling). If you are brave you can add the sibling’s spouse for the annual gift. The result is that you can give $56,000 or $112,000 combined using the Gift Trust in this example.

There is no leverage with a direct gift. You are limited to the one time annual exclusion gift. (Currently $14,000 or $28,000 for a couple “splitting” the gift between them.)

8. This is anecdotal, but I think it is fair to say that folks doing direct gifts rarely file gift returns and have no record and defense against an audit later.

Direct or in trust, either way, I would suggest filing a gift tax return to evidence the annual exclusion gifts/forgiveness. This creates a good record of the gifting too.

9. Exclusion from the beneficiary’s estate for tax purposes.

Exclusion is provided in a Gift Trust that has beneficiaries that follow after the current primary beneficiary. A direct gift is in the taxable estate of the beneficiary at his/her death.

10. A built in succession plan for the trust contents

- to the sibling, his descendants, and his/her spouse or charities as the beneficiary may in the future elect. No kids? It goes to other persons you will have selected as defaults. Direct gifts are unplanned and unstructured after the gift is made.

11. Generation skipping leverage for you

- to the extent that your gifts may terminate in the hands of nieces and nephews, you qualify the gifts for exemption from generation skipping transfers because you intend to stay within the annual exclusion from GST limits (the same $14,000 amount). You have no opportunity for such leverage with direct gifts or bequests to siblings.

12. Trust earnings will be taxed to the beneficiaries to the extent paid out.

If held and not distributed, the earnings will be taxed to the trust grantor. This is important so that the trust itself does not get hit with income taxes at the trust level.

Paying the income tax can either further reduce the donor’s taxable estate without it being considered a gift, or can be taxed to the beneficiaries who receive the income, persons who may be in lower tax brackets.

Some (like me) could argue this is a reason: Trusts are more fun to do.

This is a TRUSTworthy Consideration™. Do good with it.