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TRUST & INVESTMENT

UPDATE

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Ten questions about trusts

Once upon a time, few Americans had access to, or even knew about, financial tools like 401(k)s, college savings plans, and reverse mortgages. Today, many families turn to these products without a second thought. The same might be said for trusts.

Often associated with the vast wealth of families like the Kennedys and the Rockefellers, trusts are finding a place in more Americans' estate plans, no matter what the size of their assets. We are always pleased to have the opportunity to explain a subject that is, for too many people, shrouded in mystery.

Here are some of the more frequently asked questions.

1. How much will I save in taxes with a trust?

Trusts are not primarily about saving taxes, although they will always be designed with taxes in mind. Many ordinary trusts provide no income tax savings at all, with the conspicuous exception of irrevocable charitable trusts.

For the largest estates, trusts can be used to reduce the cost of future estate and/or inheritance taxes. Although that is a good goal, the preservation and management of an inheritance for a beneficiary is normally the most important consideration.

2. What sort of investment return will a trust deliver?

No simple generalizations are possible about investment returns from trusts, because trusts may invest in anything. The fact that assets are being managed through a trust tells one nothing about the assets themselves.

In the typical case, a trust will contain a diversified portfolio of stocks, bonds, and mutual funds. An asset allocation plan will be developed for the trust, consistent with the purposes of the trust.

3. Then what is the purpose of the trust?

A trust provides for family financial protection. It creates a structure for delivering financial resources to multiple

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beneficiaries over a span of time, sometimes generations. Current beneficiaries receive the trust income, and others receive the trust principal in the future, when the trust terminates. Many trusts also authorize the distribution of principal to current beneficiaries in some circumstances. See the checklist below for samples of specific trust purposes.

Checklist of possible trust purposes

No single trust can do everything, but for almost any imaginable need, there is a matched trust solution. How many of these objectives do you have?

- ☐ Continuous financial management in the event of incapacity
- ☐ Professional investment management
- ☐ Financial support for a special needs person
- ☐ Financial privacy
- ☐ Probate avoidance
- ☐ Lifetime financial protection for a surviving spouse
- ☐ Asset management for inheritances
- ☐ Creditor protection for heirs
- ☐ Inheritance for children from an earlier marriage
- ☐ Lifetime protection for a disabled child
- ☐ Future legacy for charity
- ☐ Current income for charity, keeping assets in the family at lower cost
- ☐ Protection from current and future estate taxes

4. How is the income from a trust determined?

Traditionally, trust income consisted of interest and dividends. Capital gains and losses were charged to principal. However, in this century there has been a trend toward looking at total return from an investment portfolio.

The short answer these days to this question is: exactly in the way that the grantor wants the income to be determined. Some grantors have provided for "unitrust" income interests. For example, a trust could pay the income beneficiary 4% of its value, determined each year. Some have been satisfied with the traditional definitions of income. Still others have given their trustees the flexibility to make adjustments each year between the income and principal of a trust. Many states have enacted laws in recent years encouraging this latter approach.

5. How is a trust different from other investment accounts?

A trust has an independent legal existence that makes it durable. It can survive the incapacity or death of its creator. The trustees continue to manage the trust according to its stated purposes, stepping into the shoes of the person who created the trust.

6. What is a living trust? I've seen lots of advertisements about them.

Living trusts are so named to distinguish them from testamentary trusts, which are created with a will and take effect after death. A living trust goes into operation during life. Usually, such trusts are revocable and created for the benefit of the grantor. Living trusts are popular for three key reasons:

- ***Sound asset management.*** The trustee will provide professional supervision of the portfolio, consistent with the grantor's vision.
- ***Protection in the event of incapacity.*** Trust management continues even if the grantor becomes unavailable for any reason, such as major health problems.
- ***Probate avoidance.*** Estate settlement is a public process, and it can be a lengthy one. Living trusts normally avoid probate completely, creating a zone of financial privacy. They continue to function, providing financial resources to beneficiaries, while the estate settlement process continues.

7. Will a trust protect assets from creditors?

As a general rule, one cannot use a trust to shield assets from one's own past or future creditors (although a few states are experimenting with changing these laws as to future creditors).

One can, however, use a trust to protect assets from the claims of beneficiaries' creditors. The traditional example is the wayward son-in-law. A concerned parent might designate a daughter and grandchildren as beneficiaries, to avoid giving the son-in-law a chance to squander the fortune. But the roles could easily be reversed to, for example, protect a son's inheritance from divorce claims.

8. Can I change my mind after I create a trust?

That depends upon what sort of trust we're talking about. A charitable trust is normally irrevocable and can't be modified. A trust in a will can be changed simply by amending the will.

Usually, this question arises about revocable living trusts, and in that case, the answer is yes—you remain in full command. You can change the beneficiaries, add assets, withdraw the assets, or even terminate the trust should you decide that it is not right for you and your family.

9. Whom should I choose as my trustee?

Choose us. We have the financial strength, the investment capability, and the experience that you need to make implementing your trust plan a success. You want a trustee who will be fair and impartial, and more importantly, you want the beneficiaries to recognize and respect that impartiality. Your trustee needs to manage your trust all year long, not be away on vacation or dealing with other pressing business. Again, that's us.

How can I learn more about trusts?

Make an appointment to meet with one of our trust professionals at your earliest convenience. We hope that this brief summary has stimulated your thinking and triggered at least ten more questions about how trust planning might benefit you and your family. One of our officers would be pleased to meet with you to discuss your situation and assemble the information that you need to move ahead with a trust of your own. ☐

Charitable trusts versus donor-advised funds

For the philanthropically minded, the charitable trust has long been a sound strategy for setting aside substantial funding for a charity. A charitable trust allows for both private and charitable interests. A *charitable remainder trust* (CRT) is a permanent financial arrangement. The grantor transfers assets to the trust, which pays an annual income to lifetime beneficiaries, typically the grantor and/or spouse. The trust may continue for a specific term of years (up to 20), or it may last for the joint lives of the income beneficiaries. When the trust terminates, the assets pass to a designated charity. An income tax deduction for the actuarial value of the remainder interest is permitted when the contribution is made to the trust.

A *charitable lead trust* flips the picture, providing an income stream to a designated charity for a specified number of years, and then the assets themselves return to the family when the trust terminates.

An alternative approach to setting aside money for charity, short of an outright gift, is a contribution to a *donor-advised fund* or DAF. The DAF holds the funds and accepts suggestions in the future from the donor for making grants, but is not legally required to follow those suggestions. The donor irrevocably parts with the contribution to be able to secure the charitable deduction. However, as a practical matter, the DAF is likely to accept the donor's advice in most cases.

DAFs have become big business. According to a 2023 report by the National Philanthropic Trust, nearly 2 million DAFs were holding $229 billion in assets in 2022. That year DAFs received $86 billion in new money, and they distributed about $52 billion in grants.

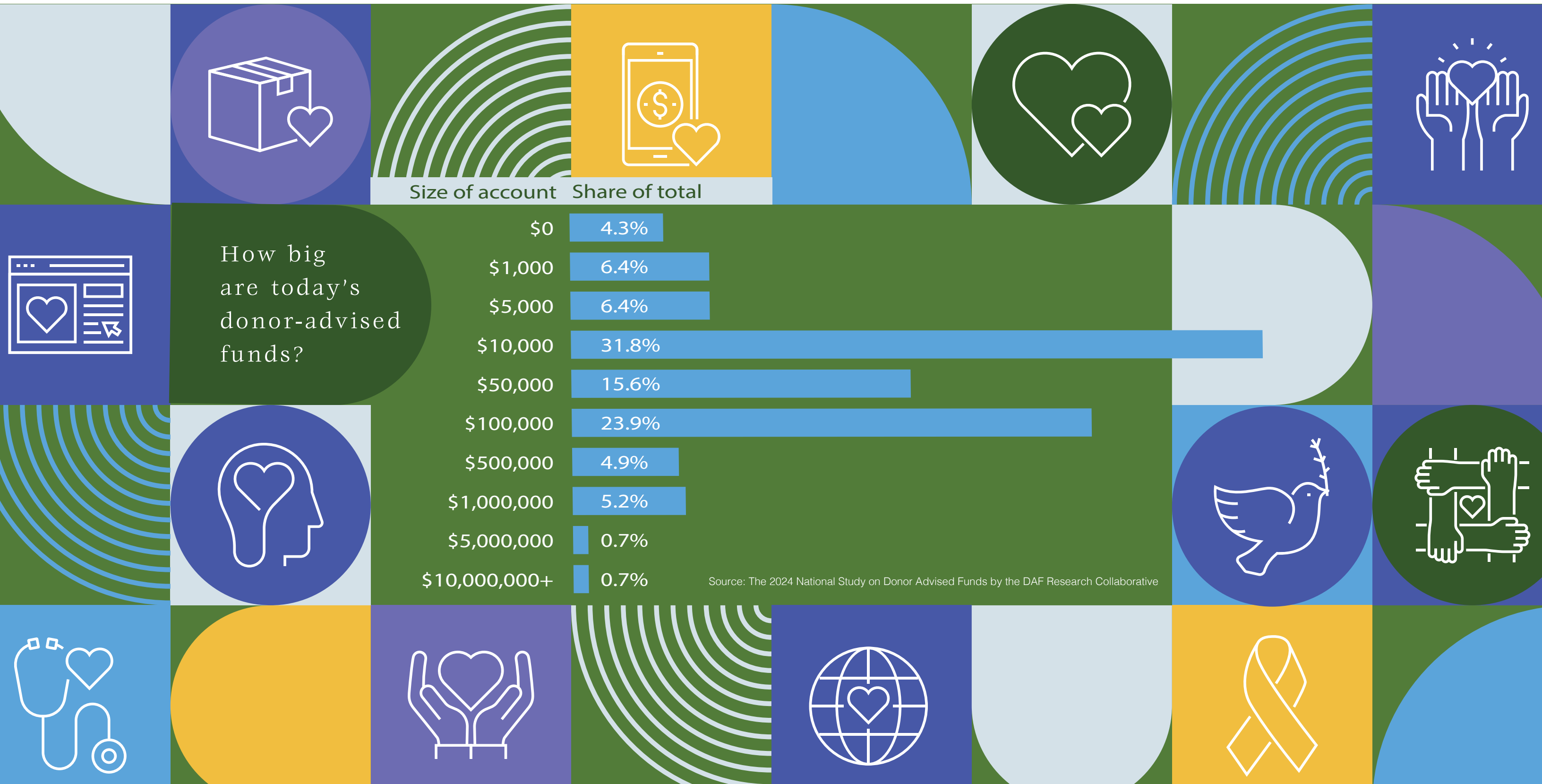
Concerns

Some members of Congress have expressed concerns about the timing mismatch between when the taxpayer gets the charitable deduction (upon funding the DAF) and when the charities receive the money (when future grants are made). The IRS issued proposed Regulations on DAFs in November 2023, and it has received hundreds of comments in response.

To provide factual information about this strategy, the DAF Research Collaborative conducted an extensive study of DAF practices over a period of years, with findings published at https://johnsoncenter.org/wp-content/uploads/2024/02/DAFRC_Report.pdf. They learned:

- Half of all DAFs had total assets of less than $50,000, and only 7% had $1 million or more (see bar chart below).
- The median payout of DAFs was 15%, and the average payout was 18%.
- Some 97% of DAFs are advised by individuals or families; 49% of advisors were baby boomers.
- About 54% of DAFs granted out half of their original contribution within three years.
- About 58% of DAFs granted out 100% of their original contribution within eight years.
- The DAF is a mid-range philanthropic strategy: 38% of contributions were from $10,000 to $49,999; 15% were from $50,000 to $99,999; and 19% were from $100,000 to $499,999.

Are you interested in becoming a philanthropist? We'd be pleased to offer our insights in this area. ☐



Under the radar?

The IRS is beginning to spend the additional funding allocated to it in the Inflation Reduction Act. On February 21, 2024, the Service announced that an early effort is going to be audits to determine whether corporate jets are ever used for personal travel.

The cost of a corporate jet is fully deductible to the extent that the jet is used for business purposes. If an executive uses the jet for personal travel, the value of that usage is taxable income to the executive. Any personal use may also affect the deductions taken by the business.

IRS Commissioner Danny Werfel was quoted in the IRS announcement of the new initiative: "Personal use of corporate jets and other aircraft by executives and others have tax implications, and it's a complex area where IRS work has been stretched thin. With expanded resources, IRS work in this area will take off. These aircraft audits will help ensure high-income groups aren't flying under the radar with their tax responsibilities."

This area of tax law is "complex" because any trip could have both a valid business purpose and a personal angle, such as a vacation when the business efforts are concluded.

How much money might be raised by these new audits? The IRS did not speculate, but there are an estimated 10,000 corporate jets operating in the U.S. They are worth tens of millions of dollars, and so are the deductions for owning them.

According to the IRS announcement, this is an area of tax law "which has not been closely scrutinized during the past decade as agency resources fell sharply" following the revelations of politicized IRS enforcement during the Obama administration. The IRS will be developing education materials for the operation of corporate jets, including recordkeeping requirements.

Another new enforcement effort by the IRS, focused on 1,600 millionaires, has resulted in $520 million in additional collections, according to IRS Information Release 2024-9. The Service is prioritizing high-income cases and balance sheet discrepancies in large partnerships. As of December 2023, audits of 76 of the largest U.S. partnerships were opened, employing artificial intelligence to identify compliance issues.

The IRS has been modernizing its hiring processes and holding more direct hiring events to better compete with the private sector and quickly bring top talent on board. More than 560 new accountants were hired in November and December last year, to provide the resources needed for audits of high-income individuals, complex partnerships, and large corporations. ☐