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Trusts for Families

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What is it?

There are a number of family trusts that estate planners generally no longer use, either because they have lost certain tax benefits or because they are simply no longer a favored method of gifting. These trusts include the Clifford trust, the pot trust, and the Crown trust.

Tip: *The Crown trust was once a popular income-shifting device used for educational funding. Today, estate planners no longer use Crown trusts.*

Clifford trusts

A Clifford trust, also known as a short-term trust, is a trust arrangement where the grantor places income-producing property in a trust for a minimum time period of 10 years and a day. The trust agreement places all the incidents of ownership with the trustee. At the end of the trust period, the assets are then returned to the grantor of the trust. It is for this reason that a Clifford trust is sometimes called a reversionary trust. In other words, the grantor of the trust reserves the principal, and the income is paid to the trust beneficiary. Clifford trusts were used to shift ordinary income to family members who are in lower brackets for a short period (less than 10 years) without giving up ultimate ownership of the trust property. Prior to the elimination of its tax benefits, the Clifford trust was a widely used method of shifting income.

Are Clifford trusts used today?

The 1986 Tax Reform Act eliminated the tax benefits that were afforded to Clifford trusts. Prior to the Tax Reform Act, a transferor could retain a reversionary interest in a trust and avoid being treated as the owner of the trust, as long as the trust was to last at least 10 years or for the life of the beneficiary of the trust income. Currently, any reversionary interest that is retained by the grantor will cause the grantor to be taxed as the owner. However, this taxation is limited to situations where the interest is worth more than five percent of the value of the interest at the time the trust is created. Because of this change instituted by the 1986 Tax Reform Act, Clifford trusts are no longer being created. However, some Clifford trusts that were previously created are still in existence.

Grandfathering of the Clifford trust

The Tax Reform Act of 1986, which revised the grantor trust rules, does not apply to Clifford trusts that were in existence on March 1, 1986, as long as the transfers made to the trust were either on or before that date. However, if a beneficiary of a grandfathered Clifford trust is under the age at which the kiddie tax kicks in (generally, beneficiaries under the age of 19, but see tip below), only the grantor will avoid taxation; the beneficiary will be taxed at the parents' tax rates.

Tip: *Children subject to the kiddie tax are generally taxed at the parents' tax rates on any unearned income over a certain amount. This amount is $2,300 (in 2022) (the first $1,150 (in 2022) is tax free and the next $1,150 (in 2022) is taxed at the child's rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support.*

What can you use instead of a Clifford trust?

Grantor retained annuity trust (GRAT)

A grantor retained annuity trust (GRAT) is the reverse of a Clifford trust. Unlike a Clifford trust, where the grantor gifts trust income, but retains the remainder, the grantor of a GRAT retains a right to annuity payments while the remainder goes to the trust beneficiary. While a GRAT does not have any immediate income tax benefits (i.e., the grantor continues to be taxed on the income), its use may result in estate tax savings.

Qualified personal residence trust (QPRT)

Today, many estate planners use a qualified personal residence trust (QPRT) in place of the Clifford trust. A QPRT is an irrevocable trust to which you transfer an interest in a personal residence, and then retain the right to use the property for a number of years. A QPRT can result in reduced gift and estate taxes.

Pot trust

A pot trust, also known as a single fund trust, is a trust in which assets are placed until the occurrence of one or more events, at which point the assets are distributed to the beneficiaries of the trust. For example, a pot trust will distribute all of the trust assets when the youngest of several children reaches a certain age, or will distribute the assets in portions when a child marries or purchases a home. Until the triggering of the distribution event, all trust assets are maintained in a single pot for the benefit of all the beneficiaries. The trustee of a pot trust has the ability to make disproportionate distributions among the beneficiaries of the trust, according to the beneficiaries' needs. While a pot trust is extremely flexible because the trustee has broad discretion to distribute trust assets, it often leads to disputes among family members. These disputes usually result from the trustee's tendency to favor one child over another.

What can you use instead of a pot trust?

Individual trusts

Individual trusts for each line of descendants can avoid family disputes that might accompany pot trusts. The way an individual trust operates is that assets are divided into separate trusts for each child. This individual allocation of definite amounts to each child can result in fewer familial conflicts.

Dynasty trust

Another option is to use dynasty trusts in place of pot trusts. A dynasty trust passes assets in the trust down through as many generations as possible. Typically, very wealthy families who wish to maintain their wealth through multiple generations use a dynasty trust. Similar to a pot trust, a dynasty trust grants broad powers to the trustee when distributing income or principal to the beneficiaries.

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