Preserving Lasting Legacies with Dynasty Trusts

by Philip Herzberg, CFP®, CTFA, AEP®

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How can you optimally incorporate dynasty trust planning for your clients, who wish to create a lasting financial legacy for children, grandchildren, and future descendants? Leverage dynasty trusts as tax-efficient techniques to enable your clients' families to transfer assets to subsequent generations, while removing all future appreciation on such assets from their taxable estates.

Know that married clients in 2016 may give $10.9 million to a dynasty trust for their children and grandchildren without incurring any gift, estate, or generation-skipping transfer taxes (GSTT) on the transfer. Be wary that the dynasty trust may be exempt from the GSTT to the extent the donors allocate their available GSTT exemption to the trust.

States follow the "rule against perpetuities," limiting the legal life span of a trust to no more than 21 years after the death of the youngest beneficiary alive at the time a trust was created. Note that some states have a longer statutory period than others. With the counsel of an estate planning attorney, you should confirm applicable state law relating to the maximum allowable period of the dynasty trust.

Careful dynasty trust planning is essential to creating a meaningful legacy. Assess the following estate planning considerations to help your client and their families preserve lasting legacies with dynasty trusts.

Important Tax and Non-Tax Advantages

Life insurance may be a purposeful wealth planning solution for funding your client's dynasty trust with assets or investments producing high possible appreciation and little or no transfer tax value today. Note that some life insurance vehicles offer contractual guarantees, which means the policy cannot lapse or premiums will stay constant.

Further, gifts to the trust to pay the premiums may qualify for the gifting and the GSTT exemption, with the death benefit proceeds payable to the trust passing outside of your grantor clients' estates, as well as the estates of the future descendants covered by the dynasty trust. In conjunction with an estate planning lawyer and qualified tax professional, you may design dynasty trusts to make annual exclusion gifts of premiums to the trust (in 2016 it's $14,000 per donee) so that the money is not subject to gift taxes and may be immediately enjoyed by the trusts' recipients.

Your clients can also reap prodigious tax benefits through dynasty trust planning, especially when assets, expected to increase in value over time, are transferred to the dynasty trust before a liquidity event occurs. Be mindful that this strategy is useful for when a liquidity event is anticipated in the future, such as when a business goes public or is involved in a strategic merger or acquisition.

Prudent asset location is pivotal to effective dynasty trust planning. Because income generated within a dynasty trust is more heavily taxed, it may be more advantageous to place assets in the trust that are non-income producing, such as growth stocks, tax-exempt bonds, and real estate.

Greater Creditor Protection

Know that access to trust property by the beneficiaries should be limited to maximize asset growth potential and preserve principal for future heirs. Advise your grantor clients to decide how narrow or broad their beneficiaries' access will be within those limits. Understand that dynasty trusts may be structured to give beneficiaries wide latitude to safeguard trust assets against potential claims by creditors, such as divorcing spouses.

Dynasty trusts may be devised so that the trustee has sole discretion, coupled with a spendthrift provision, to properly make tax-free distributions to your grantor clients' children, grandchildren, or future descendants. The spendthrift clause will restrict irresponsible beneficiaries from squandering the dynasty trust's principal on gambling, drugs, or other reckless behaviors. Consequently, the rights of these beneficiaries are limited and creditor protection is maximized.

Keep in mind that a grantor client who wishes to provide a beneficiary with as much control as possible may nominate the beneficiary as trustee and give the beneficiary the discretion to use trust principal limited by the ascertainable standard of health, education, maintenance, and support. Educate your grantor clients that less creditor protection is available when beneficiaries have the right to demand a distribution under other circumstances or have the authority under the dynasty trust to name a successor trustee in place of a trustee who is not making distributions.

Seeking Longer-Term Flexibility

What can you do to address your clients' concerns about what their future family legacy will look like and the uncertainty of the kind of tax rules their direct heirs will face? Increase your grantor clients' flexibility and alleviate potential issues by employing a trust protector, a designated individual with the power to modify an otherwise irrevocable dynasty trust.

Decanting assets is another estate planning technique that can be used for a change in future family circumstances, such as when a beneficiary needs exorbitant medical care, or for when a trust has staggered distributions to beneficiaries at different ages. In essence, decanting a dynasty trust involves pouring the assets from an old trust to a new one with more favorable trust administration. With the oversight of a seasoned trust attorney, you should confirm that state law statutes permit decanting so that the trust can be moved to a favorable jurisdiction for dynasty trusts.

If decanting is not appropriate for your clients' situation, think about employing a family limited partnership (FLP) or family limited liability company (LLC) in tandem with the dynasty trust. Recognize that a FLP or family LLC can be a viable way for your clients' families to minimize taxes and transfer assets between generations, while still retaining some added flexibility. Adjustments may be more readily made to management, which generally affect how wealth is distributed to limited partners, as well as what types of investments are made.

Perpetuate Family Values

Prepare a mission statement to identify your clients' family values. Realize that wealthy families should pass along the family vision for their assets even when the operation of a business is no longer a concern.

Dynasty trusts may drain the initiative of your grantor clients' children or grandchildren to work, since they will receive continuous trust income. Your clients' family value in this mission statement might be that all family members need to earn their way in the world by having their own careers and that they should not be able to regularly rely upon family money. Dynasty trust funds should be accessible to assist descendants with significant and expensive life events, such as college education and mortgage down payments.

Encourage your clients' family members to engage in philanthropy by using a dynasty trust in tandem with a private foundation as part of an overall strategy. Be cognizant that these techniques are most suitable for dynasty trusts and private foundations with substantial assets. Formulate dynasty trust provisions that give your grantor clients' beneficiaries a distribution of some percentage of their charitable giving every year. ■

The author thanks Ana Cela Harris, J.D., CFP®, founder and president of Cela Advisors, in Miami, Florida, for her assistance with this article.

Editor's note: For more on decanting and modifying trusts, see "Altering Irrevocable Trusts: Bringing flexibility to the inflexible" in the March issue.