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A New Year's Resolution to Legacy Planning

How the 'great transfer' can be less taxing for clients

By Mitchell H. Caplan

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The New Year is here. Clients are thinking about the future. And with an estimated $30 trillion predicted to transfer from Baby Boomers to their heirs over the next three decades, legacy planning should be a top priority. Advisors need to ensure that their clients are prepared for this massive shift of assets, which Accenture calls the "greater" wealth transfer.

Nearly two-thirds of RIAs and fee-based advisors polled in Jefferson National's most recent survey on the topic say legacy planning is important or extremely important to their clients. This New Year, the most successful financial advisors will focus on tax-advantaged legacy planning solutions that help clients preserve and pass on their wealth to loved ones or to their most important philanthropic causes. In this article, we will discuss a unique approach to legacy planning that can minimize the impact of taxes on trust income and help clients accumulate more wealth.

A New Approach: The Tax-Advantaged Trust

Trusts are widely used for legacy planning, especially by advisors serving high net worth and ultra-high net worth clients. Findings from Jefferson National's Legacy Planning Survey show that 72 percent of RIAs and fee-based advisors say they use trusts for wealth transfer – and for good reason. Trusts can be used to specify exactly how – and when – assets pass to beneficiaries, help reduce estate and gift taxes, avoid probate and protect assets from creditors and lawsuits.

However, the benefits of trusts can be severely impacted by the burden of high tax rates on trust income – even at low thresholds. In 2015, for example, the maximum tax rate of 39.6 percent came into effect at just $12,150 of trust income, compared to $413,200 of income for an individual taxpayer. This has inspired many advisors to take a more innovative approach toward funding a trust by leveraging the power of tax deferral.

Wes Martin, Founder and Principal of Martin Financial Group, puts it succinctly: "Many of our high net worth clients are never going to spend all their money in their lifetime. They're going to leave it to their family." His firm has started using tax-deferred variable annuities as a solution for funding trusts. This allows him to control when trust income is generated and when taxes on trust income are paid – to help clients accumulate more wealth. Martin is among the innovators in his field who are currently using VAs to fund trusts. And in the coming year, 60 percent of RIAs and fee-based advisors plan to increase their use of tax-deferred variable annuities when funding trusts, according to Jefferson National's Legacy Planning Survey.

Funding Trusts with IOVAs to Accumulate More

But, as Martin notes, traditional VAs rarely work for funding a trust – due to high asset-based fees, limited fund choices, costly commissions and complex guarantees. Instead, he relies on a new generation of Investment-Only Variable Annuities (IOVAs) to ensure that clients will benefit from the greatest possible tax-deferred wealth accumulation.

IOVAs are designed to maximize tax-deferred growth with lower costs, a simple transparent structure, and the broadest choice of underlying funds. By providing a tax-advantaged investing platform with all asset classes, including liquid alternatives and managed volatility funds, IOVAs allow advisors to build portfolios that are truly diversified and can provide downside protection with upside potential. Like Martin, 80% of advisors surveyed agree or strongly agree that a low-cost IOVA with more investment options and no riders would better serve a client's trust needs than a traditional variable annuity.

Capitalizing on Asset Location

When funding a trust with an IOVA, tax deferral can provide added benefits. In the first of a series of Investing Insight whitepapers, Jefferson National's Chief Investment & Research Officer Thomas J. Quinn identifies a strategic approach to managing taxes with Asset Location. As his study shows, by locating the most tax-inefficient assets in tax-deferred vehicles, and locating tax-efficient assets in taxable accounts, asset location is a proven strategy to increase returns 100-200 bps per year.

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"There's a very direct relationship between paying less in taxes, and earning higher returns. Using an IOVA for asset location is a proven solution to increase tax alpha – and increase returns – without increasing risk," said Glenn Frank, CPA/PFS, MS Taxation, Director of Investment Tax Strategy at Lexington Wealth Management and President of Frank Advising. "For that part of a client's portfolio that needs to be tax-sheltered, a low-cost Investment-Only VA is an automatic fit. For high net worth clients, who do not need immediate liquidity, it's often an essential piece of the portfolio to build up long-term growth."

Different Trusts Offer Distinct Benefits

When using an IOVA to tax-optimize trusts, there are important guidelines. The trust must act as an "agent of a natural person" for any type of annuity that will be used. Further, there are distinct types of trusts that keep the annuity's tax-deferral intact, and each of these can offer specific advantages to minimize, delay or eliminate trust income, helping reduce the tax burden to increase accumulation. The most common types include:

- Revocable trust. Valuable for grantors in a high tax bracket, to avoid investment income during working years, and leverage tax deferral until taking a distribution. Typically adopted for three reasons: 1) assets in the trust will avoid probate at death; 2) Trustee can manage trust assets if grantor is unable or unwilling; 3) Trust terms dictate transfer of assets after grantor's death, acting as a "will substitute."
- Net Income with Makeup Charitable Remainder Unitrusts (NIMCRUTs). Reduce taxation of highly appreciated assets and take tax deductions for charitable contributions the year the NIMCRUT is established. Retain ongoing stream of income, while controlling the timing of income distribution until it is needed in retirement.
- Credit shelter trusts/Bypass trusts. Part of a plan to reduce estate taxes, set up by one spouse for the benefit of the surviving spouse and any children. If surviving spouse has sufficient resources for current needs, putting assets into an IOVA keeps current trust income to a minimum – and saves more future assets for children. Consider holding one annuity for each child within the trust, making it easier to distribute when the trust terminates.

- Special needs trusts. Keep trust assets separate from the assets of the special needs child to help preserve Supplemental Security Income and Medicaid benefits. Premature distributions from the IOVA will likely be exempt from 10% IRS penalty for early withdrawal since the annuitant is likely to be disabled.

Recognizing the power of simple low-cost tax-advantaged investing, a growing number of advisors are using Investment-Only VAs to help their clients and their heirs build more wealth. “We seek the best investment solutions for our clients and their families to help them build wealth that can last for a lifetime and beyond,” said Linda Lubitz Boone, CFP®, Founder, President and Chief Compliance Officer of The Lubitz Financial Group. “We have seen the tangible benefits of using low-cost no-load variable annuities to help many of our clients maximize the power of tax deferral and optimize their legacy plans.”

To make the most of this great transfer of wealth over the next three decades, RIAs and fee-based advisors will be working closely with their clients and their clients’ heirs to develop plans that ensure their legacies will grow and endure for many generations. With an extensive lineup of funds and virtually no contribution limits, the benefit of tax-optimizing trusts with low-cost, no-load, tax-deferred IOVAs is clear.

By helping clients control how much is paid in taxes – and when those taxes are paid – advisors can effectively create more wealth for their clients, their clients’ heirs and causes that matter to them most. Not only in this New Year, but for many years ahead.