Why Use Legacy Trusts?

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“Legacy trust” (commonly known as “dynasty trust”) is a term the estate planning community uses for any trust that lasts perpetually. Although the idea of creating dynastic wealth through trusts has been around for hundreds of years, the legacy trust as it is currently understood began in 1983 with state laws (e.g., South Dakota and Delaware) that eliminated the rule that required trusts to end at a certain time. For purposes of this discussion, a “legacy trust” is any trust created under Delaware or South Dakota law that has no fixed ending date.

Legacy trusts can be used for many different purposes: To provide extended relief from federal or state transfer taxes; as long-term incentives for certain types of family behavior; and to bring continuity in the operation of a closely held family business. They can be used for very specific, long-range purposes, such as ensuring that all of the grantor’s descendants can afford to go to college or make a down payment on a home. That is why the term “legacy trust” is more useful than the term “dynasty trust.”

Background: Why Trusts?

Before discussing legacy trusts specifically, it’s best to discuss why trusts are useful for estate planning in the first place. Simply, a trust is a contractual arrangement between three parties: the person who creates the trust (known as the “grantor” or “settlor”), the person who takes title to and manages trust assets (known as the “trustee”) and the persons for whose benefit the trust is created (known as the “beneficiaries”). The grantor transfers assets to the trustee who agrees to administer the property according to the trust agreement for the benefit of the beneficiaries.

Trusts are essentially protection devices used in several different contexts. First, they can protect a beneficiary when that beneficiary is unable to manage assets on his or her own behalf (for example, if the beneficiary is a minor or is suffering from a physical or emotional disability). Second, trusts can protect beneficiaries from each other (as is the case when beneficiaries can’t agree amongst themselves on the way property should be managed or distributed). Third, trusts can provide a beneficiary access to trust property while keeping it from being subject to estate tax (either federal or state) at the beneficiary’s death. Finally, a trust can protect trust assets from attachment by a beneficiary’s creditors (often including a beneficiary’s ex-spouse).

Why Legacy Trusts Specifically?

Rather than thinking of a legacy trust as something totally unique, it may be better to think of it as a regular trust that’s been supercharged. Every one of the trust benefits described above can be obtained to an even greater extent in a legacy trust.

Greater Flexibility

Many grantors want beneficiaries (or other third parties) involved in the trust decision-making process, even if they can’t be trustees. One possible solution is for one or more of the beneficiaries or third parties to be a “trust protector,” essentially an advisor to the trustee with limited authority. The trust protector might have the job of removing and replacing the trustee, moving the situs of the trust and supervising certain types of investments. To help avoid estate tax problems, a committee can be created to serve as protector, and if a beneficiary is also to be a trust protector, then another member of the committee should be a different beneficiary with an adverse interest, whose consent is required to make certain decisions.

South Dakota and Delaware also allow for “directed” trusts, similar to a trust protector, under which a general trustee in that state is named, but another individual is given responsibility for one particular decision (for example, when to make distributions to beneficiaries).

Finally, both states allow for “decanting” of trusts—that is, pouring out the assets of an old trust into a new trust created in South Dakota or Delaware. This is still a relatively new concept, and there are open tax and legal questions that should be discussed with your legal and tax advisors before undertaking it.

Greater Tax Savings

Federal and state governments impose two taxation systems on individuals and trusts: income tax and transfer taxes (that is, estate, gift and generation-skipping transfer taxes). These are parallel systems with very little overlap. Legacy trusts can provide planning opportunities for each.

First, consider income tax. Trustees must pay state and federal income taxes on trust income that is not distributed to beneficiaries. This can be a significant liability, especially when the trustee sells a trust asset that has appreciated significantly in value and then reinvests the sale proceeds. Although legacy trusts do not offer any benefits in relation to federal income tax liabilities, when they are located in a state (like South Dakota or Delaware) with no state income tax, they do not have to pay income at the state level. Note that states have become more aggressive in attempting
to tax a beneficiary’s undistributed income. Therefore, when establishing a legacy trust, it is important to consult with your legal and tax advisors to determine what roles beneficiaries may play during the trust administration.

Transfer tax savings can be even more significant than those associated with state income taxes. The federal government (as well as many states) taxes everything you transfer: if you make the transfer during your lifetime there is a potential gift tax liability, and if the transfer takes place at death there is a potential estate tax liability. Further, if you make that gift to a person two or more generations below you (most often grandchildren), there is a second level of transfer tax, known as the generation-skipping transfer tax or GST tax, that also can apply.

However, there are many exceptions to the imposition of this tax. First, there are annual exclusions from the federal gift tax up to a certain amount (which is why you pay no gift taxes on most birthday presents). Most importantly for this discussion, every person has an exemption amount from federal estate, gift and GST taxes. This amount has changed a great deal from just 15 years ago, when it was $600,000. As a result of the Taxpayer Relief Act of 2012, the exemption amount is $5 million indexed for inflation beginning in 2012. For 2013, the exemption amount is $5.25 million.

If a grantor transfers that “exempt” amount to a multi-generational trust that is drafted appropriately, then no federal gift tax is due on the transfer, there is no federal transfer tax on the distributions from the trust and no federal estate tax on the deaths of the grantor or any of the beneficiaries. Although transfer tax rates vary at the state level, this may be the case for state transfer taxes as well.

Combining these tax savings in a legacy trust can be very powerful. First, there may be no need to pay state income tax and capital gains taxes on trust assets. Second, under this trust structure, no federal transfer taxes are paid for the life of the trust. If that trust lasts indefinitely, then the combined savings can be dramatic. After a generation or two of prudent asset management, the value of legacy trust assets can grow significantly without these tax “drags.”

Greater Creditor Protection

If an individual is the beneficiary of a trust created by someone else (say, a parent or grandparent), then the assets inside that trust are difficult for the creditors of that beneficiary (for example, an ex-spouse of the beneficiary) to reach. This protection is not available if the assets are left to the beneficiary outright. Because legacy trusts are multi-generational, they may provide even greater creditor protection. This determination, of course, is a matter of state law and changes depending upon where the beneficiary lives. However, it is safe to say that a legacy trust provides much greater creditor protection than simply giving the assets outright to the beneficiary.

Factors to Consider When Creating a Legacy Trust

Deciding to create a legacy trust is the easiest part of the process. The real challenge is creating a trust that can last indefinitely. The trust terms must be specific enough to ensure that trustees who may never have even met the grantor will administer the trust in a manner consistent with the grantor’s wishes. However, they also must be flexible enough to allow the trustee to consider changed circumstances and laws that the grantor could never have anticipated.

Choice of Situs

The choice of state law in creating a legacy trust is critical because only certain states (most notably Delaware and South Dakota) allow a trust to last in perpetuity, impose no state income tax on the trustee, and provide flexibility in the ongoing administration of the trust. In order for a grantor to create a trust that takes advantage of the laws of a particular state, however, generally the trust must be administered in that state. So, for example, if a California resident wants to create a legacy trust in Delaware, he or she will probably need to name a corporate trustee that has a Delaware office, and ensure that the trust actually is administered there. In other words, the state of administration must be chosen first, based on the best set of state laws to accomplish the grantor’s goals, and then a trustee residing in that state must be chosen that is qualified to act.

Identifying the Purpose

The paramount question when creating a legacy trust is “why?” To be truly valuable, a legacy trust should be an essential part of the settlor’s vision. Begin with the question, “if I created a trust that lasted forever, what would I want it to do?” What follows are some examples of ways that the “vision” for a legacy trust can be determined. They are not designed to be exhaustive, but merely to illustrate ideas that some individuals may consider when faced with the unique set of circumstances.

Family Values: The Family Mission Statement

The process of preparing a legacy trust really is no different than the process of estate planning itself. Done properly, it involves identifying those issues that are most important to you as the grantor. The importance of family values, however, becomes even more obvious when creating a legacy trust because it lasts so long that it points out clearly the strengths and weaknesses of the plan. One starting point for defining your vision might be to define the values your family holds most important.

Perhaps the best way to determine a family’s values is to prepare a mission statement. The importance of such a mission statement is most clear in family businesses. The same should be true, though, for families that have other
types of wealth (large securities holdings, for example). Wealthy families still should pass along the family vision for the wealth even when the operation of a business is not an issue. Discussing asset management, financial training, education and philanthropy all can be important aspects of a family’s cohesiveness and healthy functioning.

**Giving Family Members a “Leg Up”**

Once the family has developed its mission statement, perhaps one of the best ways to begin the process of crafting the document is to determine the type of “model” to follow. One model that might be appropriate, for example, is the “leg up” model. In this type of plan, the family value might be that all family members need to make their way in the world by having their own careers and that they should not be able to rely upon family money to simply drift. However, family money should be available to help with certain key (and expensive) milestones or life events. The trust might make distributions, for example, for family members’ medical insurance, education (including not only college but also private elementary and secondary schools) and down payments for a house.

**The Legacy Trust as a Retirement Plan**

Many grantors feel they do not want to give significant wealth to their descendants at all, fearing that by doing so they will drain the initiative of those descendants. On the other hand, they also want to make sure that their descendants have a “safety net” in the event that unforeseen problems arise or that the descendants have chosen careers that do not lead to substantial retirement wealth (for example, social services work). This is another situation in which a legacy trust can prove particularly useful. The model here might be the legacy trust as retirement plan replacement, under which distributions from the trust are available for support, education and medical care, but only in the event that the trustee determines that there has been an emergency that requires such distributions. Once the beneficiary reaches retirement age, however, the emergency requirement is removed, and the trustee can begin making distributions for health, education and support without regard to the beneficiary’s circumstances.

**Encouraging Philanthropy**

Most (though not all) grantors would agree that encouraging philanthropy is a good idea. In our experience, however, very few of them have a systematic way of encouraging philanthropy. While there is no substitute for parental involvement, modeling charitable behavior and developing family volunteer opportunities, a legacy trust can be used to help in the process. It can be used in conjunction with a private foundation as part of an overall family strategy. Using the two in conjunction allows family members to be involved in different aspects of family asset management at different times. If the assets in the legacy trust and private foundation each are of sufficient size, the family may be able to pursue investments that are available only to larger investors.

The legacy trust distribution provisions can also be drafted to incorporate charitable giving by the individual. This can be done by giving trust beneficiaries a distribution of some percentage of their charitable giving each year (for instance, the trustee will distribute to each beneficiary an amount equal to half of that beneficiary’s contributions made to qualified charities for which the beneficiary can produce adequate documentation). In this way, the trust makes it easier for beneficiaries to pursue philanthropy while not actually doing it for them.

**Preserving the Family Business**

A primary concern of many grantors who have founded a successful family business is how that business will be maintained by future generations. Often the grantor will “anoint” one child to be the successor, which often creates hard feelings among siblings and other family members. A legacy trust can be an effective tool in this circumstance; it can operate as a voting or control trust, designed to prevent one person from steering the business away from its original vision.

**Conclusion**

In addition to the tax-efficient advantages of a trust, it also offers flexibility and provides a family with the means to establish a financial legacy that passes along family values as well as money.
Endnotes

Over the years, many other states have joined in and enacted legislation either eliminating this “Rule Against Perpetuities” or substantially extending the allowable duration of such trusts.
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