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WEALTH MANAGEMENT

Tax Efficiency: Effective Strategies for the Long Term

When it comes to wealth management, planning is everything. At BNY Mellon Wealth Management, planning underscores each of the five practices within our Active Wealth framework: investing to maximize compounding; borrowing strategically; spending dynamically; managing taxes; and protecting legacy.

That last practice — protecting legacy — is where some of the most critical planning decisions occur. After all, one of the most important goals in creating sustainable, multigenerational wealth is to leave behind a legacy that supports an individual's family, values and philanthropic interests. This requires a significant amount of planning, both financial and non-financial, to protect assets against any unintended consequences — including taxes — that might threaten long-term goals.

Tax efficiency can help reduce the detrimental effect that federal, state and local taxes on income, estates, capital gains and property can have on wealth. Tax-efficient investing can help combat costs in the short term, but there are other techniques that can mitigate costs over generations.

Let's explore some of the techniques that can help achieve generational tax efficiency.

Tax Efficiency Planning Over Generations

Dynasty Trusts

Funding trusts can have tremendous transfer tax advantages. The most basic type of trust planning involves transferring assets to an irrevocable trust for the benefit of a group of beneficiaries. The trust could be drafted to meet the trust creator's (or grantor's) wealth transfer goals. For example, the trust might direct that the grantor's children receive all income from the trust assets and that they receive distributions of principal for certain needs, such as education, starting a business or buying a home.

The tax advantage derived from trust planning is realized when the trust grantor shifts assets out of his or her estate into a trust. Because that transfer is taxable for gift tax purposes,[1] this planning is most effective when trusts are funded with assets that have strong potential for significant future appreciation.

A variation on the general trust planning theme is a dynasty trust. In the recent past, certain states have passed laws that allow trusts to have perpetual life, hence the "dynasty trust" moniker. While a number of states have such legislation, perhaps best known is Delaware, which is characterized by a body of well-developed trust law. If structured correctly, a Delaware dynasty trust will allow the grantor to transfer assets into the trust, and those assets can remain in trust for many generations, insulated from estate taxes and state income taxes. In addition to Delaware, other states with favorable trust laws are also available for dynasty trusts, but are only appropriate if there is no state tax on accumulated income or capital gains in trusts. Exhibit 1 illustrates the benefit of gifting to a dynasty trust that is able to grow free of transfer taxes over multiple generations.

Exhibit 1: Wealth Transfer Strategies- Generation-Skipping Dynasty Trust

Scenario		Initial Funding	30 Years	60 Years
Scenario #1	Assets Gifted to Dynasty Trust	$11,580,000	$37,559,000	$121,817,000
Scenario #2:	Assets Included in Recipient's Taxable Estate	$11,580,000	$27,167,000	$52,868,000

Notes:
1. Trust assets under both scenarios increase by 4% annually.
2. Scenario #1 shows initial funding of the generation-skipping tax (GST) exemption amount that can pass free of transfer tax to subsequent generations under a properly structured irrevocable trust, which is exempt from estate and generation-skipping taxes.
3. Scenario #1 assumes application of the entire GST exemption amount per person available in 2020.
4. Scenario #2 assumes the assets pass outside of a trust to persons subject to a 40% federal estate tax on the entire distribution occurring once every 30 years (passing of a generation and federal exemption levels remain static).

Enhanced Tax Benefits of Combining Entities

Optimal pre-transaction planning may involve combining multiple techniques to exploit the best aspects of several strategies. A basic dynasty trust can easily be combined with other trusts, entities and strategies to further enhance the return.

For instance, the trust could start out as a Spousal Lifetime Access Trust (SLAT). By funding this popular form of trust that benefits their spouses, grantors remove assets from their taxable estates while still providing access to trust funds through their beneficiary spouses. Children and other descendants can be current and/or remainder beneficiaries.[2] If there is little likelihood that the beneficiary spouse will need to access the trust assets, the remainder could be structured as a dynasty trust.[3]

Similarly, an irrevocable trust that owns life insurance policies on the life of the grantor or lives of the grantor and spouse could become a dynasty trust after the death(s) of the insured. To the extent these funds aren't needed to pay estate taxes[4] they can remain in trust, bypassing estate or gift tax at each successive generation. These Irrevocable Life Insurance Trusts (ILITs) are highly tax-efficient, as they avoid both income and transfer taxes if structured and administered properly.

Grantor Retained Annuity Trusts (GRATs) and Intentionally Defective Grantor Trusts (IDGTs) are other forms of irrevocable trusts that provide for assets to be transferred to future generations at a reduced transfer tax rate. In these cases, the grantor receives a stream of payments from the trust for a period of years, at the end of which the remaining assets are distributed outright or in an ongoing trust to descendants.[5] The extremely low assumed rates of return that the IRS currently applies when calculating the value of the remainder make these powerful tax-saving structures.

Combining a dynasty trust with a family limited partnership (FLP) is a powerful way to further reduce the gift tax incurred when transferring assets into a trust. Gift taxes are reduced due to a discounted valuation[6] for the limited partnership units that fund the trust. The tax benefit of the dynasty or other irrevocable trust may be even more pronounced if a discounted initial value of the contribution is available. When family wealth consists of a family business, large real estate holdings and/or other illiquid assets, FLPs provide further benefits in the form of centralized management and control and creditor protection. These "non-tax" reasons are important in avoiding IRS challenges on the discount.

Conclusion

Reducing tax burden is particularly important over the long term, given the powerful effect of compounding over many years as well as the high estate tax rate. Estate and gift taxes are likely to become even more burdensome for families who have worked hard to build wealth to support future generations.

Good estate planning is critical to preserving family wealth over multiple generations and can substantially increase after-tax returns by mitigating — and in some cases ending — the drag from both income and estate taxes.

There are many solutions even beyond generational planning (such as domicile planning, charitable planning or life insurance premium financing) that could help maximize your wealth plan. The key is to start planning early, continue planning as internal and external circumstances change and seek advice from experienced professional advisors.

[1] The grantor's remaining gift and estate tax exemption could offset this but this would reduce the grantor's remaining exemption available for future gifts and bequests.

[2] A remainder beneficiary inherits trust assets either outright or in an ongoing trust, after the current beneficiary passes away or no longer has an interest in the trust.

[3] In addition to the appropriate distribution and other provisions in the trust, generation-skipping transfer tax (GSTT) could be allocated at the initial funding, providing for maximum tax efficiency.

[4] Payment of estate taxes is a common motivation, but not the only motivation, for purchasing life insurance within an irrevocable trust.

[5] In a GRAT, the remaining assets at the end of the term typically distribute to children rather than grandchildren or more remote descendants, as the GSTT exemption cannot be allocated to the GRAT until the end of the term.

[6] Valuation is discounted for minority discount, lack of control and lack of marketability.

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