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DYNASTY TRUSTS - Protecting Your Wealth for Generations

Outright Distribution vs. Dynasty Trust

Many people think that the best way to pass their estate to the next generation is to do it directly - i.e. each child receives a check for their share of the inheritance and the estate is closed.

However, more and more people are thinking multi-generationally and instead of passing their estates directly, they are passing their estates using "dynasty trusts." Dynasty trusts benefit one generation of family members by protecting the inheritance from estate taxes and protecting it from creditors and divorcing spouses.

Wealth that is not reduced by estate taxes or subject to creditors / divorcing spouses has the potential to grow more then wealth that is subject to estate taxes at every generation or further reduced by claims from creditors / divorcing spouses.

Dynasty trusts are a golden opportunity for you and your family. By planning for your children, grandchildren, great-grandchildren, etc., you can give your family many generations of estate tax-protected, creditor-protected, spouse-protected wealth.

Consider this tale of Two Families:

Knight vs. Day

The Knight Family: John Knight inherited $1.5 million from his parents directly. He received a check for $1,500,000 and deposited it into his personal bank account. He *owned* it.

The Day Family: William Day didn't inherit anything from his parents directly. Instead, they left his $1.5 million inheritance in a dynasty trust that named William as the trustee and beneficiary. William could *control* the $1.5 million as trustee and could *enjoy* the $1.5 million as beneficiary. But he did not technically own the money, his parent's trust owned it.

You might think that John, who inherited his $1.5 million directly, would be happier than William, who inherited his $1.5 million in a trust. But if the Knight family knew what the Day family knew, John would not be happier. If John could see the future, he would see it is better to *control and enjoy* wealth, rather than *own* it.

Let's compare the Knight family's future to the Day family's future to see why.

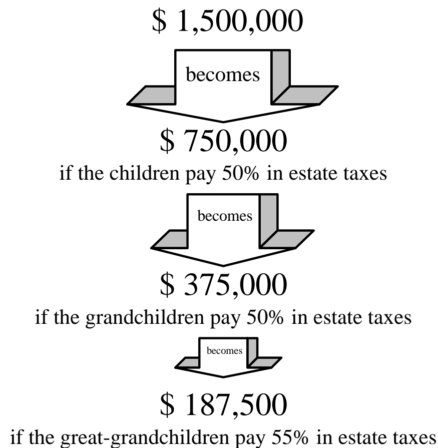
The Knight Family

Estate Taxes:

Congress gives tax relief, Congress can take it away.

The Estate Tax was first enacted in 1797, repealed in 1802; enacted again in 1862, repealed in 1870; enacted again in 1898, repealed in 1902; enacted again in 1916; reformed in 1930; reformed in 1976; reformed in 2002. Congress gives tax relief, Congress can take it away.

Currently, estate tax rates start at 41% once estates reach $1,000,000 and rise to 50% when estates reach $3 million. Since the government taxes everything we own at death, John will pay estate taxes on his $1.5 million inheritance because he owns it outright. And the government will tax the inheritance every time it passes from one generation to the next because each generation will *own* what they inherit.



For example, assume that John has his own estate of $1.5 million to add to his $1.5 million inheritance. If John and his spouse pass away in 2003 without proper planning, he will pass an inheritance to his two children worth **$2,075,000** after paying $925,000 in estate taxes.

Assume that his two children split the inheritance and each receive $1,037,500, assume their estates grow at 5% per year for 20 years, they pay income tax at 28%, then they pass away with $1.5 million of their own assets. Their estates will be worth $3,604,666 apiece and they will each pass **$3,557,556** to their children after paying $47,100 each in estate taxes. This assumes that the estate tax is eliminated for the year 2010 and then "sunsets" back to 2009 levels.

But assume that estate taxes are re-instituted ten years later back to 2002 levels before the children pass away. Now the estate passed down to the next generation is **$2,383,380** apiece after paying $1,221,286 apiece in estate taxes.

Creditors / Lawsuits:

Lawsuits can wipe out inheritances long before estate taxes do.

Lawsuits can wipe out inheritances long before estate taxes do. If you lose a lawsuit and the judgment is in excess of your insurance limits, the creditor / plaintiff can go after your personal assets to satisfy the judgement.

For example, John may cause a car accident where the property damage and personal injury judgements were in excess of his auto insurance limits. The lawsuit creditors can go after his personal assets - family home, bank accounts, investment accounts, and his inheritance - to pay the judgment.

The postman could slip on John's sidewalk, a neighbor child could fall off the swing-set or drown in his backyard pool, the cleaning lady could fall off a chair while cleaning his house; his teenage child could get into an accident with the family car; etc.. If John is a doctor or professional in a similar high-risk, lawsuit prone industry, there are the added risks of incurring liability at work that could affect John's personal assets.

John may go into a nursing home when he is elderly and the state could force him to "spend down" his assets, including his inheritance, until he is practically penniless in order to receive assistance in paying nursing home costs of $50,000 to $100,000 per year.

He may start up a business that fails and have the creditors of the business come after his personal assets, including his inheritance. He may have some large medical bills that are not covered by health insurance that could cause him to go bankrupt and loss all of his assets, including his inheritance.

Divorcing Spouse:

Besides the risks from the outside world, there are risks that come from within the family. Unless you diligently keep your inheritance separate from your marital property, a divorcing spouse can claim one-half or more of your inheritance in a divorce, adding financial loss to personal loss.

> There are risks that come from within the family.

For example, John may get divorced from his spouse and the divorce judge may award half of the marital property, including the inheritance that John failed to keep separate from his spouse, as a marital settlement to his ex-spouse.

Accidentally Disinherit the Family:

You can accidentally disinherit your children, especially when you rely on joint tenancy for your estate planning. This is especially a problem in second marriage situations whether you are divorced or remarry after your spouse passes away later in life.

> You can accidentally disinherit your children.

Assume John divorces his spouse. After a few years, John remarries and has additional children with his new spouse. He adds his new spouse on all of his accounts as a joint tenant, including what is left of his inheritance that was not taken in his divorce. If John dies first, all of his assets will

automatically go to the new spouse via the joint tenancy, leaving nothing for John's children from his first marriage.

Now assume that John and his original spouse live a long and happy life and his spouse predeceases John. After a few years, John marries a new lady friend and adds his new spouse on all of his accounts as a joint tenant, including his inheritance. If John dies next, all of his assets will automatically go to the new spouse via the joint tenancy, leaving nothing for John's children from his first marriage.

The Day Family

Control and Enjoyment Without Ownership:

Control and Enjoyment without Ownership

Unlike John Knight, William Day's $1.5 million inheritance is owned by his dynasty trust, not by William directly. William can spend all trust income, can enjoy the use of trust assets, and can control the trust as trustee, but he will not be deemed to own the trust's $1.5 million.

For example, just like John Knight, assume that William has his own estate of $1.5 million to add to his $1.5 million inheritance. If William and his spouse pass away in 2003, utilizing trust planning, he will pass an inheritance in trust for the benefit of his two children worth **$3,000,000** after paying $0.00 in estate taxes. *That is $925,000 more than John Knight's children received.*

Assume that the trust share for each child is worth $1,500,000, assume the trust assets grow at 5% a year for 20 years, the trust pays it's own income taxes at 39.6%, then each child passes away owning $1.5 million of their own assets, their estates will be worth $4,219,707 apiece and they will each pass **$4,219,707** to their children after paying $0.00 in estate taxes. *That is $662,151 more than John Knight's children received.* This assumes that the estate tax is eliminated for the year 2010 and then “sunsets” back to 2009 levels.

But assume that estate taxes are re-instituted ten years later back to 2002 levels before the children pass away. That doesn't adversely affect the Day Family since all of the Day family's inheritance is sheltered by trusts so the next generation would still receive **$4,219,707** after paying $0.00 in estate taxes. *That is $1,836,327 more than John Knight's children received.*

Creditors / Lawsuits:

You cannot lose what you do not own.

You cannot lose what you do not own. Being the beneficiary of a dynasty trust is like having a millionaire uncle who gives you anything you need, whenever you want it. Though your lifestyle reflects your uncle's wealth, you are not wealthy. Your uncle is.

If William loses a lawsuit, goes into a nursing home, starts a business that fails, incurs large medical bills, etc, his dynasty trust share is not be affected. The creditors can still get at William's personal assets but his dynasty trust assets cannot be taken away from him.

<u>Divorcing Spouse</u>:

Again, you cannot lose what you do not own.

You cannot lose what you do not own.

If William is divorced by his spouse, his dynasty trust cannot be taken away from him. His spouse may still receive one-half or more of all of the marital assets, but William will still have 100% of his inheritance in the dynasty trust.

<u>Accidentally Disinherit the Family</u>:

Dynasty trusts can direct that the inheritance stays within the family.

Dynasty trusts can direct that the inheritance stays within the family. As long as the money stays within the trust, it will be distributed down the family tree if that is what you want it to do.

If William divorces and remarries, or if he remarries after his spouse passes away, his inheritance will never go to the new spouse and his children will not be accidentally disinherited. The inheritance is for William only to enjoy, and when he passes away, it will go to his children (if that is what the dynasty trust directs). The money will never leave the family tree unless you say so.

<u>The choice: Outright Distribution or Dynasty Trust?</u>

Outright Distribution vs. Dynasty Trust

If your will or trust provides for an outright distribution of wealth to your heirs, consider updating your estate plan to include dynasty trust provisions instead. You can include dynasty trust protections in any estate plan.

You can create many generations of estate tax-protected, creditor-protected, spouse-protected wealth by making the right choice between outright distributions and dynasty trusts. The difference is as clear as Knight and Day.

If you have any questions about your specific estate planning situation, please contact our office.