

## **What is the Biggest Legal Loophole in the Tax Law Today? by W. Bailey Smith**

An important aspect of your estate plan is the manner in which your assets will pass to your children to provide the maximum benefit. One available option which has grown in popularity is the “Family Legacy Trust,” also known as the “Dynasty Trust,” because it is intended to provide a source of funds for your family for generations to come.

Over time, the value of these funds is likely to increase substantially. For example, a trust initially funded with \$500,000 and growing at 7% annually would be worth over \$1,900,000 after 20 years, approximately \$7,500,000 after 40 years and nearly \$29,000,000 after 60 years. Due to this dramatic potential for growth, creating such a trust requires careful planning to address a variety of important issues.

A Family Legacy Trust is usually intended to exist for an extended time period, often including multiple generations. For that reason, such a trust is commonly designed to provide flexibility for changing circumstances while also protecting trust assets from unnecessary taxation and attack by creditors. A Family Legacy Trust may be an irrevocable trust you establish to receive gifts you make during your lifetime, or it may be created upon your demise pursuant to the terms of your living trust. In either case, the underlying goal is similar - to enhance the benefits of the assets passing to your heirs by placing them in the protective form of a continuing trust.

As Trustees of the trust, your children will have control over trust property, including deciding trust investments. The trust will provide income to your children and, to the extent necessary, allow the children to invade trust principal for their benefit. However, for most children, distributions of principal from the trust will be unnecessary because their needs will be met by having the trust invest for the children’s behalf. For example, if a child wishes to purchase a home, the trust may purchase the home and allow the child to reside in it rent free. Using this approach will allow the investment to maintain its status as a protected trust asset.

When properly prepared, the trust will serve as a barrier to insulate assets it owns from the reach of outsiders. In this manner, the trust property will be protected from the claims of the children’s creditors, such as a former spouse in the event of divorce or other potential liability arising from lawsuits related to accidents.

Similarly, the assets of the trust are exempt from additional future estate tax upon the death of a child. The general rule is that family wealth is taxed at the end of each generation. This means that the assets parents leave to their children will be taxed as part of the children’s estate when the children die. A way to avoid this double taxation is by using the Family Legacy Trust.

Children are often puzzled when they learn that their inheritance was left in a generation skipping trust. The name of this trust implies that the decedent skipped the children. In fact, however, the decedent left the assets in a way **to skip a generation of estate taxes** when the children die and to provide protection for the children during their lifetime.

The intended long term nature of the trust also means provisions should be made to accommodate future changes in circumstances. One manner of providing this flexibility is to grant to your children the power to specify who will become beneficiaries following the child's demise. This so called "power of appointment" will give your children the ability to direct the passage of property to the next generation in the most preferable way. Likewise, those you name as Trustee may be allowed to appoint their successor, to ensure an appropriate person is always available to carry out your wishes as expressed in the trust agreement.

The following illustrations demonstrate the powerful economic effect of skipping one or more generations of estate tax. Assume your child inherits \$500,000 from you, but it is not structured as a Family Legacy Trust and instead passes to your child directly. With a 7% growth rate over 20 years, your child's inheritance will grow to \$1,900,000; however this amount will then be subject to estate tax of about 50%, or \$950,000, which will leave only \$950,000 to pass to your grandchildren. When this \$950,000 is held by your grandchildren for 20 years at 7% growth, it will then be worth about \$3,675,000 and at their death will again be subject to additional estate tax of approximately \$1,837,500. As a result of this multiple taxation, your great-grandchildren will receive only \$1,837,500, instead of \$7,500,000 which would be available simply with the use of the Family Legacy Trust. Of course, the impact of this tax cost grows larger and larger with each successive generation, as reflected in the following charts:

#### **WITHOUT FAMILY LEGACY TRUST**

	<u>Amount Inherited</u>	<u>Amount Owned At Death</u>	<u>Estate Tax</u>	<u>Net to Heirs</u>
Children	\$ 500,000	\$1,900,000	\$ 950,000	<b>\$ 950,000</b>
Grandchildren	950,000	3,675,000	1,837,500	<b>1,837,500</b>
Great - GC	1,837,500	7,100,000	3,550,000	<b>3,550,000</b>

#### **WITH FAMILY LEGACY TRUST**

	<u>Amount Inherited</u>	<u>Amount Owned At Death</u>	<u>Estate Tax</u>	<u>Net to Heirs</u>
Children	\$ 500,000	\$ 1,900,000	\$ 0	<b>\$ 1,900,000</b>
Grandchildren	1,900,000	7,500,000	0	<b>7,500,000</b>
Great - GC	7,500,000	29,000,000	0	<b>29,000,000</b>

Clearly the financial gains passing to your heirs are greatly enhanced by the avoidance of tax offered by the Family Legacy Trust. Importantly, this tax savings is only one of the major benefits offered by this type of trust, as it also provides protection to your children from lawsuits, divorce, conservatorships and probate problems.

In summary, these are some of the benefits a Family Legacy Trust provides to your children:

- The assets in the trust are protected from lawsuits, e.g. car accidents, bankruptcy, the IRS;
- The assets in the trust are protected from divorce because they are maintained as the separate property of the children;
- The trust avoids both conservatorships and probates;

When the children die, the assets avoid estate tax; they will “skip” a generation of taxes when passing to your grandchildren.

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