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DYNASTY TRUSTS—ASSET/TAX PROTECTION

By Lee R. Phillips, JD

In a simple world, there are two basic types of trusts – revocable and irrevocable. In order for promoters and attorneys to market themselves, they create "special trusts" and give them special names. For example, living revocable trusts are known as family trusts, shelter trusts, A–B trusts, QTIP trusts, Loving Trusts, and so on. Irrevocable trusts similarly have various versions that are known by different names, including complex trusts, children's trusts, insurance trusts, dynasty trusts, asset protection trusts, and many others.

This article will focus on the irrevocable trust marketed as the "dynasty trust" or the "asset protection trust." These trusts were created first in Alaska in 1997 and are sometimes called Alaskan trusts. Offshore trusts are also often called "asset protection trusts," but in this article the offshore trust will be ignored. You have to have a lot of money and be quite gullible to do offshore trusts today. Basically, you have to have more money than brains to do offshore trusts. For me and my students, offshore is basically a "no thanks."

A number of states, like Maryland, will allow a trust to go on for multiple generations, but their "dynasty" trusts are not the type of trusts this article is going to talk about. The "dynasty trusts" we are talking about in this article are self-settled irrevocable trusts that avoid income taxes, estate taxes and give great asset protection.

The goal is to protect assets from taxes and creditors plus to move the assets through at least several generations without subjecting the assets to estate taxes as they pass from generation to generation. A number of states including Alaska, Delaware, Nevada, Rhode Island, South Dakota, and Utah have enacted laws similar to the Alaskan laws. "Dynasty trusts" or "asset protection trusts" created under these states' laws aren't your common trusts.

In the most common scenarios of trust design, a revocable living trust (the one you use for estate planning) or an irrevocable trust (such as an insurance trust) is established so that the trust property is distributed to the beneficiaries, i.e., the children, when they reach a certain age where they are considered to be mature enough to handle the property. After the property is distributed, the trust "terminates."

When you set up a traditional irrevocable trust, the property you put in the trust will be taxed as a gift when you put it into the trust. The trust is irrevocable, so you are permanently giving up the

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KRISTY'S KORNER

By Kristy S. Phillips, JD

I walk three miles every morning with a neighbor. It takes us about 50 minutes and we cover a lot of ground both physically and in our conversations. It has been hard not to talk about the economy and how its effects are changing our approach to everything. We are both being far more frugal and trying to save. Let's face it, losing up to 40% in the stock market and more in our housing portfolios has had a very sobering effect. Our husbands are both self employed and we have to build our own retirements. Last year's meltdown means that our husbands are going to have to work an extra 5 to 10 years, just to recoup our losses. She and I are trying to save more to help make up for those retirement plan losses.

My neighbor and I are not just saving to rebuild our retirements. We also have concerns about Federal spending. We are not sophisticated economists, but we both feel like the government cannot continue this reckless spending.

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property to the beneficiaries. In a traditional irrevocable trust, you will not be the beneficiary, because the object is to remove the property from your creditors' reach and your estate so that it won't be hit by estate taxes when you die. If the irrevocable trust is set up right, the property held in the trust will be "outside of your estate" when you die and won't be subject to estate taxes. When the terms of the trust are followed and the property in the trust is distributed to the beneficiaries, the trust will terminate.

If you set up a revocable trust, the property you transfer into the trust isn't considered to be "gifted" to the beneficiaries. After all, the trust is revocable. You can revoke the trust and get the property back any time you want. Because you have that control over the trust and its assets, the property isn't protected from your creditors, and it will be included in your estate for estate tax calculations. As far as the IRS and the courts are concerned, the property in a revocable trust will always be "owned" by the person who established the trust and can revoke it. When the property is distributed to the children, the trust will terminate.

Once the beneficiaries (your kids or grandkids) get their distribution from the trust, whatever type of trust it is, the property is theirs. They own it. They pay income tax on any income generated from the property. It is included in their estate for estate tax calculations. If they set up an irrevocable trust and transfer the property into the trust, it is a gift. The whole process of asset protection, tax planning and estate planning starts over again.

Until the Alaskan laws were passed that let the trust go on in perpetuity (forever), trusts in the United States had to end according to the "rule against perpetuities." The rule states that the trust has to end 21 years after the last to die of all the trust beneficiaries who are living when the trust is created. (Note that Dad's living trust is considered to be "created" when he dies and the trust changes from a revocable trust to an irrevocable trust. Yes, all living trusts automatically change on the death of the creator of the trust.) If a great grandchild is living when the trust is created and lives to be 100, the trust could extend up to 21 years after the great grandchild's death. The states that have passed dynasty trust laws will allow the trust to go on in perpetuity, or at least 999 years.

Because the trust is irrevocable and the special dynasty trust laws are written to protect the trust's assets from creditors of the grantors and beneficiaries, the assets are pretty safe. The states that have implemented dynasty trust laws have not only designed their laws to protect the trust's assets from creditors, they have also designed the laws so that money earned in the trusts is not subject to state income taxes.

One unique feature of the Alaskan type trust is the trust is a self-settled trust. That means that the guy who makes the trust can also be the beneficiary. Before the Alaskan laws (which some other states have followed), you couldn't set up an irrevocable trust and be a beneficiary if you wanted to get the estate tax and asset protection advantages of an irrevocable trust. It is a big deal to be able to set up your own irrevocable trust and get the good advantages of the trust, while being able to get benefits from the trust. Before these new laws, only your kids and grandkids could get the benefits of the trust. You can now enjoy income from the trust during your lifetime. (Yes, you have to pay income taxes on the money you get from the trust.) The trust will be protected from your creditors of all types, and it will not be subjected to a gift tax or estate tax for many generations. A true legacy. (These trusts are sometimes called legacy trusts.)

If you take advantage of the new irrevocable "dynasty trusts," the property can be held in the trust for the benefit of your children, your grandchildren, and possibly even your great grandchildren and beyond. The property will be subject to a gift tax when you put it into the trust, because the trust is irrevocable. However, if it remains in the dynasty trust, it could pass through several generations escaping exposure to any more gift taxes and no estate taxes. Dynasty trusts avoid the generation-skipping transfer tax (GST) which imposes a 55% tax on all property passed where a generation is skipped. The GST is in addition to the gift and estate taxes. If your estate passes to your grandchildren, rather than your children (if the children are living), then the tax is automatic, and you can easily lose all of the property. However, Congress did give each person a $1,000,000 exemption for the GST. So, unless you are passing over a million dollars to your grandkids, you don't need to worry. However, if you have a larger estate (over $5 million), the dynasty trust is something that will give your family tens of millions of dollars more over the next 100 years.

Under the laws that are coming, the trust might become attractive to those who only

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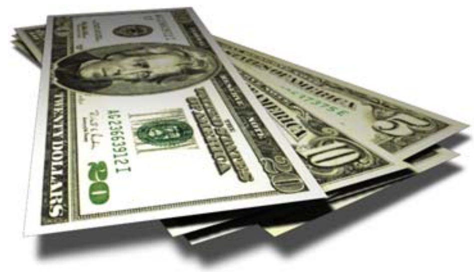
DYNASTY TRUSTS—ASSET/TAX PROTECTION, CONT.

have a million dollars in total assets. (Yes, "only" a million is a good problem to have – would that we all had such problems.) The hidden problem is, you can easily have a million dollars in the eyes of the IRS and still be clipping coupons out of the newspaper every Sunday. You need to evaluate and watch what your net worth is, especially as inflation kicks in over the next couple of years and the tax laws change.

There are a number of drawbacks to the dynasty trusts. The trustee must be a resident of the state where the trust is established. However, residents of the state often can't establish a dynasty trust, or if they do, the advantages of the trust are largely lost. Why? Because the states that have passed the dynasty laws are looking to promote their banking industry and get out-of-state money under management within the state. By the way, you do not need to go to the state where you are going to establish the trust. There are lots of banks in each state advertising to be your trustee. They will help you set up the trust. The dynasty trust can be drafted so selected family members are co-trustees, but the state institutions are going to get a management fee. The trustee cannot be required to make distributions to you. Distributions to you have to be made "at the discretion of the trustee." The trusts are irrevocable. Once you set one up, you can't change the plan. The trust's terms are set in cement.

There are still lots of issues to be addressed concerning the dynasty trusts. How will your state's laws "respect" the asset protection promised by the dynasty trust? If you transfer assets to the trust, will your state ignore the fraudulent conveyance laws? There are things we don't know about the trusts, but they are sure better than going offshore if you want good asset protection. Just because these trusts are relatively new and we don't know all the answers about them, don't be afraid of them. The fact is, we don't know lots of things about the law. Law isn't an exact science; there is some subjectivity with each judge and jury.



Even with its drawbacks, the dynasty trusts are a good tool that can effectively be used in the right situation. In addition to passing property through several generations without subjecting it to gift and estate taxes, dynasty trusts quite effectively protect the trust property from the creditors, divorces, lawsuits, and other problems of the successive generations. They also have good income tax advantages. Dynasty trusts aren't for all families, but they can be powerful wealth transfer tools for many that you may want to consider.■

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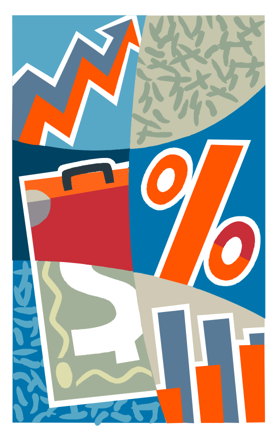
KRISTY'S KORNER, CONT.

Sadly, Federal spending is currently 28% of our gross national product. Spending like this has only happened four times in United States history. We are worried about what tax and inflationary pressures will result from such uncontrolled spending. In fact just last week, Federal Reserve Chairman Ben Bernanke urged Congress and the Obama administration to start plotting a strategy to curb record-high U.S. budget deficits. Failing to do so could eventually erode investor confidence and endanger the economy's prospects for long-term health, he said. My neighbor and I see tax deductions evaporating and more taxes coming and that makes us conservative. Of course we would like to see the economy stimulated, but we are saving because we feel insecure about our future. We wonder if the recovery may be short lived as the government will be forced to deal with the inflationary pressures it is creating by all that spending. We hope not.

We are not alone! Total personal savings jumped from $20 billion in 2008 to $453 billion during the same period in 2009. Twenty times the savings is a pretty drastic turnaround. However, nobody is shouting Hooray! In fact, it has a lot of smart people really worried. This, in spite of the fact that for years the economists have lamented that Americans have had a 0 to negative savings rate. Finally, Americans are saving and these great minds are panicked. They are worried because consumption comprises 70% of our economy. If consumers don't spend, the economy will continue its freefall. The question now is will a $2 trillion stimulus package be enough to impress consumers and get the economy moving again?■



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USING THE LAW TO MAKE MONEY

EMAIL IDENTITY THEFT

By Kristy S. Phillips, JD

I have belonged to a book club for the past 20 years. I recently received an email from one of my book club friends, Jill. It told me that she was stranded in Portugal with no money, and she needed me to wire her funds, immediately.

It sounded like a scam, but I was concerned enough to contact her. She was very embarrassed and told me the whole story. Her Gmail account got hacked and emails were sent to everyone.

She could not access her email account. She worried one of her friends might fall for the scam, but she had no way to contact her email list. She thought of using her husband's account, but she had no back up of her email list. Desperate, she called Gmail. It took several hours for the reps at Gmail to walk her through a second installation. Even then, all her email addresses and messages were gone.

Although I work with identity theft all the time, this experience hit close to home. Here are some tips you can use to avoid becoming a victim of cyber fraud:

- Never respond to unsolicited (spam) email.
- Never click on a link contained in an email, unless you are expecting it. It doesn't matter who it is from!
- Be cautious of any attached files. Those files may contain viruses. If you don't know the file is coming, don't open it. Make the sender confirm.
- Scan all attachments for viruses and only open attachments from known senders.
- Keep a back up copy of your email addresses at another site for use if there is a problem.

Do not fill out forms in email messages that ask for personal information.

Be Careful! ■