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The "Great Planning Divide" Among Wealthy American Families

News & Recognition:

FT Top Financial Advisers 2015

FT 300 Ranking June 2015

HPM Partners Named Top Wealth Manager by Forbes

Recently I was asked: what is the most noteworthy event you have seen over your twenty-seven year career in trust and estate planning?

Without hesitation my answer would be the emergence of the "Great Planning Divide" among wealthy American families. Over the past decade, wealthy families have been separating into two very distinct groups. In one group are the families who are taking advantage of developments in the law and planning to shelter vast amounts of family wealth (and sometimes all family wealth) from estate taxes and liabilities, potentially forever.

In the other group are the families who are willfully or negligently ignoring this planning opportunity. The latter group, in essence, is voluntarily choosing to contribute significant portions of their wealth to federal and state governments with the passing of each successive generation. This division in wealthy families in the twenty-first century may well determine which families will be wealthy in the twenty-second century.

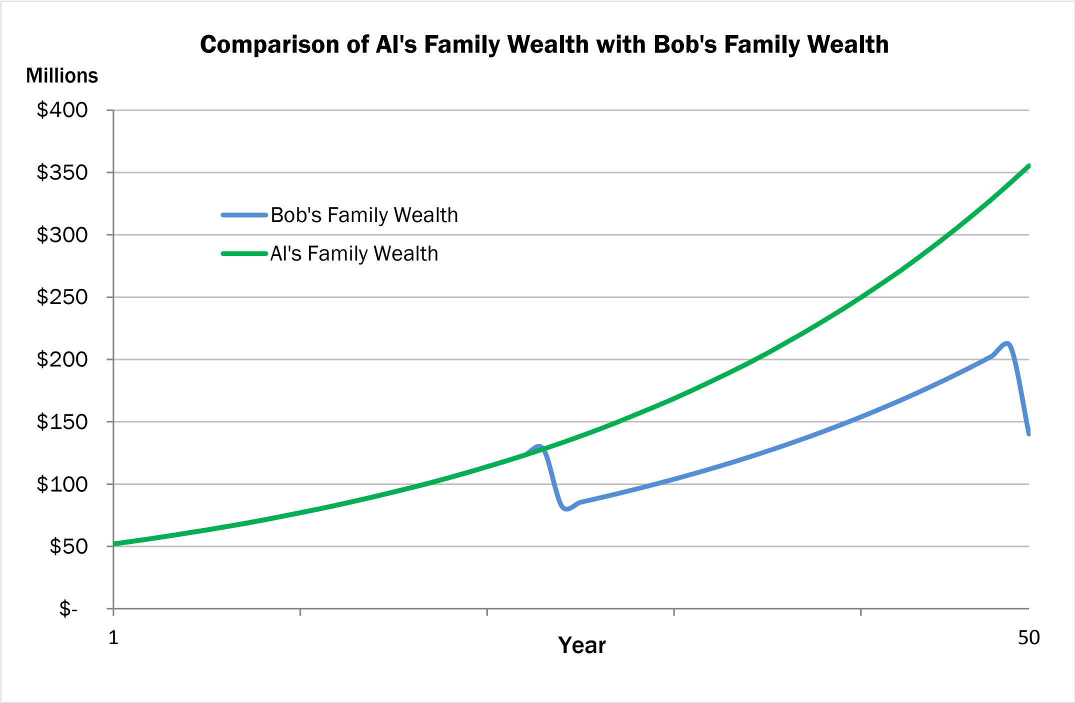
Since 2001, tax law changes have radically increased the amount of wealth that American families are permitted to transfer during their lifetime. In 1985, an individual could only transfer $400,000 to a family trust before triggering a federal gift tax. Today, thirty years later, a married couple can transfer $10.86 million to a family trust without paying any federal tax. Commonly used planning techniques may amplify and leverage this already-generous credit amount, enabling wealthy families to transfer tens or even hundreds of millions more in family wealth without any tax consequences.

Just as important as the ability to move large amounts of wealth without triggering gift or estate taxes are the powerful planning structures into which families are able to move their wealth. In recent decades, states like Delaware have modernized their trust laws to enable families to create trusts that, in theory, can continue forever. Once wealth is properly transferred into such a "dynasty trust," the trust can continue from generation to generation in a family without ever being subject to gift or estate taxes. Such trusts also enjoy a very high degree of liability protection, in the event that a family member is sued, goes bankrupt or divorces.

Why is this such a big deal? Imagine two wealthy individuals, Al and Bob, who each sold a business in the same year for same amount: $50 million. Al and Bob are both in their late 60s and divorced. Each has only one child, a daughter in her late 30s. Each daughter in turn has young children in nursery school. Al's family has created a multi-generational trust and has been able to successfully transfer $50 million in assets to the trust over a period of years.

Bob, on the other hand, has been reluctant to engage in planning, citing a desire not to "ruin" his daughter and his grandchildren with inherited wealth. Bob still holds his wealth in his own name. Both families live in the same neighborhood, invest their assets in the same way, pay income taxes at the same rate and have identical spending habits.[1] Al and Bob die twenty-five years from now in 2040, and each daughter survives her father by another twenty-five years (dying in 2065).

Where is each family fifty years from now? Al's grandchildren inherit $328 million in a creditor-protected, multi-generational trust that they can pass down to their own children at death, free of estate tax. Bob's grandchildren inherit only a little more than one-third of that amount. Bob's family has paid the federal government more in estate taxes over the past two generations than Bob's grandchildren actually inherit in 2065.



[1] This illustration assumes that both families have a 5% after-tax rate of return investments and a 1% annual "spend rate." It is also assumed that estate tax credits and rates in the future are the same as current rates.

The foregoing illustration shows only the impact of estate taxes on the family wealth of the two families. When you take into account that Al's family has had its wealth in a creditor-protected trust for the past five decades, while Bob's family wealth may have been eroded by lawsuits, liabilities and divorces over that same time, the difference between the two families is likely to be much, much greater.

This emergence of two groups of wealthy Americans—"those who plan" and "those who don't"—is having an impact far beyond the families involved. The large, multi-generational trusts that have been created by "families who plan" are becoming, in essence, "family banks," i.e. entities that are being used as a source of capital for new family investments in venture capital, private equity, real estate and other growth investments. When families have opportunities to make new strategic investments, they are often choosing to do so through their "dynasty trusts" rather than in the names of individual family members. These large dynastic trusts will be the key clients of financial institutions, and key investors in all segments of our economy, for decades to come.

Washington has taken note of the existence of these large, multi-generational trusts, and for a number of years, the Obama Administration has advanced proposals to restrict their use. However, our divided Congress has largely prevented any changes in this area of the law from happening, and many planners believe that even in the unlikely event of such changes taking place, they will only be prospective in effect, with existing trusts "grandfathered" in their current status.

A final word of hope to the "families who don't plan": it's not too late. The statutory and legal framework that has enabled your peers to create flexible, multi-generational trusts that are sheltered from estate taxes and liabilities, and to move large amounts of wealth into such trusts, still exists. Talk to the families in your community who have done the planning successfully, and to the advisors that helped them, to fully understand what you are missing. Our experienced team of wealth planning advisors at HPM Partners is available to assist with any questions you may have.

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