Dynasty Trusts

Summary: A Dynasty or Generation Skipping Transfer Tax trust minimizes transfer taxes through multiple generations of heirs while providing asset protection.

One of the most popular "buzzwords" that has recently surfaced in the area of estate planning is the "Dynasty" Trust. Ironically enough, the word "Dynasty" never appears in the Internal Revenue Code ("IRC"). What does appear in the IRC, of course, is Chapter 13, which provides a complete and largely effective system of taxation of generation-skipping transfers. The "Dynasty" Trust does sound quite impressive to clients, and certainly does add that creative marketing appeal that many of us estate planning attorneys are trying to inject into what may be our otherwise uninspiring practices. Whether you call them "Dynasty" Trusts or "Generation-Skipping Transfer Tax" ("GSTT") Trusts, as Chapter 13 of the IRC prescribes, Dynasty Trusts offer tremendous *estate tax advantages* as well as significant *asset protection* for their beneficiaries for countless generations. Dynasty Trusts give their makers ("grantors") the opportunity to provide for their children, grandchildren, great-grandchildren and so on through the generations with wealth that is both *estate tax-protected* and *creditor-protected.*

A dynasty trust maximizes the time that estate and gift taxes can be avoided or deferred and the transfer tax savings can be enormous. Considering that estate tax rates climb as high as 55 percent, and that estate taxes are applied to each generation, you could save up to 80 percent of your estate through three generations. For instance, suppose you have $1 now and you die. Assuming you have an estate tax rate of 55 percent, that $1 would shrink to 45 cents before it ever got into your children's hands. Assuming their estate tax rate is 55 percent also, when your children die, that 45 cents will shrink to 21 cents. In other words, to pass on $1 million to grandchildren, you would have to start with close to $5 million.

This is where the dynasty trust becomes most effective. That $1 is not consumed by estate taxes, and is able to keep working for your heirs. In fact, if we assume a modest 6 percent annual rate of return and if your dynasty trust lasts for 100 years (which happens often), that $1 would turn into $339.30.

A Dynasty Trust provides for a number of things. Since the beneficiary does not own the trust assets and the assets are controlled by a trustee, the assets are not subject to claims of creditors, not subject to division upon divorce, not subject to a child leaving the assets to a second or third spouse, with the assets never passing on to the grandchildren.

The trust beneficiary cannot spend the principal but is limited to the fixed payments and discretionary payments (made only in the trustee's discretion).

There is not a concern that a 50 year old son will leave the assets to his 26 year old fourth wife, that a grandchild will use the money to drink, spend and have a good time (spending $500,000 in six months), or that a daughter will convert her inheritance to community property and lose half of it when her husband divorces her.

The beneficiary receives a fixed annual sum, like a variable annuity, from the trust monthly. If the beneficiary needs more money for his "health, support, maintenance, and education" and does not have funds available for these purposes, the trustee can make additional payments to the beneficiary from principal, in the trustee's sole discretion. Or the trustee can loan assets to the beneficiary. This can be a tremendously powerful way of providing heirs with a variety of opportunities while protecting them from divorce and being able to do nothing.

If a person sets up such a trust and then dies, changes in tax laws will not affect the trust and make it taxable.

While all exception creditors may generally attach a remainder interest, it appears that a remainder interest in a dynasty trust could not be attached because it is an interest that does not vest with anyone. In this respect, drafting trusts with dynasty interests should still avoid many creditor issues and should be a matter of course for most clients, not just a technique for the ultra-wealthy.

Since a dynasty trust will, at least in theory, last forever, the trustee should also exist indefinitely to provide continuity in administration. A corporate trustee is almost essential to a dynasty trust. A corporate fiduciary can provide professional management and investment skills and is more likely to keep abreast of changes in the law. Moreover, as a neutral trustee, a corporate fiduciary is far less likely to play favorites among beneficiaries, particularly if the trust is a pot trust. The grantor should therefore choose a well-established trust company or bank trust department as trustee. If the grantor is intimidated or distrustful of large financial institutions, he or she can provide that some of the trust beneficiaries shall serve as co-trustees. For example, the trust could provide that a member of each generation of beneficiaries will act as a co-trustee, as long as the proposed co-trustee is over age 25, for example. In the event that he or she could no longer serve, all beneficiaries who are then adults could vote on another beneficiary co-trustee. A mechanism such as this will guarantee than descendants will always be involved in the trusteeship.

The dynasty trust should also provide for the termination of a co-trustee, whether the co-trustee is an individual or a corporate fiduciary. Termination is often allowed by a majority of adult beneficiaries. While not a perfect solution given the dynamic nature of families, it at least provides a way to remove trustees who are perceived by a majority as unsuitable for the trusteeship.

A DIGIT is an irrevocable trust that treats the grantor as the "owner" of the trust assets for income tax purposes, but still allows the trust assets to be excluded from the grantor's taxable estate. A DIGIT is a "defective" grantor trust because the grantor possesses certain powers over the trust that cause the grantor to be the owner of the trust for income tax purposes, but not for estate tax purposes. If the grantor trust rules apply to a trust, then the trust income, deductions and credits are included on the grantor's individual income tax return, and income tax is paid at the grantor's individual tax rate. This payment of the trust income tax enables the grantor to make a tax-free gift to the trust each year, and allows the income and assets of the DIGIT to continue growmg.

Funding a DIGIT during life enables a client to reduce his taxable estate through a combination of gifts and sales to the trust. Unlike a typical IUT, which is funded with just a life insurance policy, the donor can maximize transfers to a DIGIT by funding the trust with income-producing and appreciating assets in addition to a life insurance policy. The added benefit of a DIGIT, as opposed to a nongrantor IUT, is that the grantor can pay the trust income tax, allowing more cash to accumulate and grow inside the trust. In many cases, clients may enter into an installment sale agreement with the DIGIT trustee, under which the trust purchases assets from the grantor.

DIGITs can also be set up as multi-generational "dynasty" trusts to stretch out the tax benefits over a longer period of time. As long as the grantors allocate their GST exemption(s) to all the lifetime gifts to the trust, the trust assets-including the life insurance death benefit-will be exempt from GST tax. The GST exemption does not need to be applied to sales or loans to the trust, only to gifts. Multi-generational trusts can avoid estate tax on the assets that remain in the trust and can also provide creditor protection of the trust assets for the beneficiaries.[1]

[1] "Defective Grantor Trusts: Greater Flexibility and Income Tax Leverage," *Estate Planning Journal,* Dec 2005