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 growing.

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 ILIT, 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 ILIT, 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

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MONEY

Building Your Own Dynasty

States Toss Out Restrictions On Creating Perpetual Trusts; Downside -- Fees Last Forever, Too

By RACHEL EMMA SILVERMAN
Staff Reporter of THE WALL STREET JOURNAL
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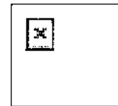

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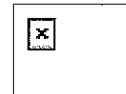

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It's getting easier to build a dynasty.

Undoing a centuries-old law that has helped stymie them, a wave of states are now allowing families to build their own economic empires by permitting so-called dynasty trusts that last forever. In these trusts -- also known as perpetual, legacy or generation-skipping trusts -- wealth stays in the family to benefit great-great-grandchildren and beyond. In the past, the law allowed such trusts to last only a few generations.

The trusts offer big tax savings and can help protect family money from creditors and ex-spouses. They're being heavily marketed by financial-services companies, which hanker after the perpetual-trust management fees and have lobbied hard for the legal changes. Franklin Resources Inc.'s Fiduciary Trust International unit, **Merrill Lynch** & Co., **Wachovia** Corp., **Charles Schwab** Corp.'s U.S. Trust unit and **Northern Trust** Corp., among others, boast Web pages describing the trusts' advantages for potential customers, or have created client newsletters and brochures that promote them.

TAKING A LONG VIEW

Reasons to consider setting up a dynasty trust:

• **To make sure your estate** provides for many generations.

• **To protect your family's assets** from estate and generation-skipping taxes.

• **To guard your family's wealth** from creditors and ex-spouses.

• **To pass along your values** to heirs with incentive provisions.

WHERE TO BUILD YOUR DYNASTY

At least 20 states permit trusts to last forever or for hundreds of years. **See five that are particularly attractive places**[0] to set up long-term trusts.

Dynasty trusts make the most sense for people with at least $1.5 million in liquid assets, so donors can leave enough money to fund the trust while still having enough cash left over to live on.

One potential drawback is that a dynasty trust could lead to nasty family disputes as the number of heirs multiplies over time. "Litigators are salivating" as dynasty trusts grow in popularity, says John Scroggin, an estate attorney in Roswell, Ga. Further down the line, in 500 years, a trust set up by a couple with two children could have a staggering 3.4 million beneficiaries clamoring for funds, according to several dynasty-trust analyses.

Ultra-affluent families have long used labyrinthine networks of trusts to protect and build their assets for future generations. The Rockefeller family's roughly 140 living descendants are worth billions, in part because of the seven trusts set up in 1934 with $102 million by John D. Rockefeller Jr., the oil baron's son. The family now uses more than 100 trusts, including numerous charitable trusts, to manage its money.

Until recently, though, even the Rockefellers couldn't use dynasty trusts, as they were illegal in most states. Trusts were often subject to the "Rule Against Perpetuities," which effectively limited trust terms to about 90 to 120 years.

But starting in the late 1990s, a number of states moved to relax their trust term limits. Now, at least 18 states and jurisdictions -- including Delaware, Wisconsin, New Jersey, Illinois, Virginia and the District of Columbia -- allow trusts to last forever. And several states that impose term limits allow much longer durations. Wyoming and Utah, for instance, permit trusts to last 1,000 years, while Florida lets them carry on for 360 years.

Growth of Wealthy Families

At the same time, the number of families with a net worth high enough to make a dynasty trust worth setting up has grown. The number of U.S. individuals with at least $1 million in financial assets -- excluding residences -- jumped to 2.27 million last year from two million in 2002, a 14% increase, according to a recent report by Merrill Lynch and consulting firm Capgemini Group.

Stepped-up marketing has helped drive client interest, estate advisers say. Mr. Scroggin, the Roswell, Ga., lawyer, says that about 30% to 40% of his clients with taxable estates now have dynasty trusts, compared with about half that four years ago. "Long-term trusts are the heart of the company's wealth-management business," says Richard Nenno, trust counsel of **Wilmington Trust** Corp. in Wilmington, Del.

If structured properly, dynasty trusts allow a family's property to grow for generations, free of

federal gift, estate and generation-skipping taxes, which can grab roughly half of a parent's wealth as money moves to another generation. Another advantage: Assets in the trusts -- which are irrevocable, meaning they generally can't be undone -- are generally protected from creditors in the case of lawsuits, bankruptcy or divorce. And although a trust that lasts about 90 years is plenty long for most people, some families don't want their trusts to dissolve at an arbitrary deadline and prefer the option of continuing a trust indefinitely.

In a typical dynasty trust, a grandparent transfers assets to a person or institution, the trustee, who holds and invests the money for beneficiaries -- the children, grandchildren, great-grandchildren and beyond. As long as money stays in the trust, it can pass from generation to generation without additional estate or generation-skipping taxes, allowing the trust to accumulate vast sums over time. After 100 years, a dynasty trust funded with $1 million could grow to $867.7 million, assuming a 7% annual growth rate, according to an analysis by Wilmington Trust.

There are many ways to fund a dynasty trust, including using life insurance or by selling interests in a business to the trust. One of the simplest ways is to make gifts to the trust of up to $1 million -- the current federal gift-tax exemption. That $1 million will appreciate during the rest of the grandparent's life and will be out of the estate. The grandparent can then leave more money to the trust at death.

There are some downsides, however. Dynasty trusts can spawn trust-fund babies, who might have less motivation to work if they know that they'll receive regular trust income. Also, as the number of beneficiaries grows over time, there's more of a chance for trust-fund disputes, like the fractious fight among the Pritzker descendants, heirs to an estimated $15 billion financial empire.

And although dynasty trusts save a bundle on taxes, they also can incur perpetual annual fees and expenses -- typically about 1% of assets under management -- which can cut into a trust's value over time. Many families draft dynasty trusts with co-trustees, using both a trust company and an individual, spelling out a process for choosing future trustees.

Once the trust is created, beneficiaries receive distributions from the trust. How much they receive, and when, is determined by the creator of the trust and set out in the trust document, and then carried out by the trustee. Some trusts, for instance, have tough incentive provisions, which means that heirs only get their share if they, say, finish college. Heirs must pay income taxes on their trust distributions. The trusts themselves are subject to federal and state income taxes.

Because dynasty trusts are intended to last for the long haul, advisers suggest making them as flexible as possible. That means including mechanisms to terminate or split the trusts as the number of heirs grows, as well as specifying how beneficiaries can switch trustees or amend the trust to take advantage of future tax laws. Last month the Treasury Department and the Internal Revenue Service issued proposed regulations that make it easier to split trusts into two or more separate trusts. That's important as the number of beneficiaries grows over time, since each heir has different interests that might be tough to manage in one trust.

Setting Up a Trust

To set up a dynasty trust, it's not necessary for families to live in a state that permits them. Only a trustee has to be located there -- and many trust companies have operations in Delaware, Florida or other states that welcome long-term trusts. Moreover, some of those states, including Florida and South Dakota, have other trust-friendly benefits, like no state income taxes and strong asset-

protection laws.

Drafting a trust typically costs about $5,000 to $10,000 in attorney's fees, depending on the complexity of the document.

Steven J. Oshins, a Las Vegas estate-planning lawyer, drafts about 150 dynasty trusts a year. One of his clients, Maryanne Ingemanson, set up a dynasty trust in South Dakota several years ago to help pass the family's primary asset -- commercial real estate -- to her two children, six grandchildren and beyond.

The "high eight figure" trust should accumulate significantly over the years, says Ms. Ingemanson, of Incline Village, Nev. Without a trust, "after about two generations it is pretty much 100% gone. The trust is effectively keeping the assets that you have worked very hard to assemble from being confiscated in a couple of generations," she says.

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Where to Build Your Dynasty

At least 20 states permit trusts to last forever or for hundreds of years. Here are five that are particularly attractive places to set up long-term trusts, because they also have favorable tax or asset-protection laws. Trustees in these states generally charge an annual fee ranging from 0.5% to 1.25% of the assets in the trust.

STATE	DURATION	PERSONAL INCOME TAX
Alaska	Trusts can last forever	None
Delaware	Most trusts can last forever, but real estate can be held in trust only for 110 years.	Delaware trusts are generally exempt from state income taxes if beneficiaries reside out of state.
Florida	Trust limit of 360 years	None
South Dakota	Trusts can last forever	None
Wyoming	Trusts can last 1,000 years	None

Return to story[0].

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Dynasty Trust

1. QUESTION 1a: Assuming a 50% estate tax and an after-tax investment return of 7.2%, and assuming your child outlives you by thirty years, if you transfer $1 million to a single generation trust in which the trust terminates when your child turns thirty, how much has your estate planning advisor cost your grandchild by failing to advise you to use a beneficiary controlled generation-skipping trust (i.e., a trust for your child and his/her descendants that is controlled by the child and is estate tax protected, asset protected and divorce protected)?

ANSWER 1a: $4 million. $1 million growing at 7.2% per year becomes $8 million after thirty years. Using a single generation trust, the IRS gets $4 million and your grandchild gets $4 million. Using a generation-skipping trust, your grandchild gets the entire $8 million.

QUESTION 1b: Assuming the same facts as in QUESTION 1 above, does the answer change if your child is sued or gets divorced?

ANSWER 1b: Yes. Using a single generation trust, the IRS gets $4 million and your grandchild gets anywhere from nothing to $4 million depending upon the severity of the lawsuit or divorce settlement. Using a generation-skipping trust (which is divorce protected and creditor protected), your grandchild still gets the entire $8 million.

QUESTION 1c: Why would anybody ever create a single generation trust when they can otherwise create a beneficiary controlled generation-skipping trust for each child (i.e., a separate trust for each child and his/her descendants that is controlled by the child and is estate tax protected, asset protected and divorce protected)?

ANSWER 1c: We can only speculate that the person must really dislike his or her descendants. [If you can come up with a better answer to this question, please email it to soshins@oshins.com.]

Back to www.oshins.com

BENEFICIARY CONTROLLED TRUST

Rather than making mandatory distributions when the beneficiary reaches a particular age (unless you want spouses, ex-spouses, creditors and the IRS to take the assets!), the trust should instead continue with the beneficiary as controlling trustee upon reaching the selected age. We call this a Beneficiary Controlled Trust. This gives the beneficiary the functional equivalent of outright ownership, but without the divorce, creditor and estate tax problems.

This approach should not be taken for beneficiaries who should not have control over the gift or bequest because of their inability to manage their own assets. For those children, an independent party should serve as trustee with the built-in flexibility for the beneficiary to become a trustee by the written appointment of a trusted party.

The IDGT strategy in a nutshell

Following is a summary of the basic mechanics of a sale to an IDGT and of the benefits it produces.

(1) The grantor creates an irrevocable trust for the benefit of his descendants.
(2) The grantor "seeds" the trust with assets equal to at least 10% of the value of the assets to be sold to the trust.
(3) The grantor allocates generation-skipping transfer ("GST") tax exemption to the trust to cover the amount of the seed money gift (if the IDGT is a **dynasty trust**). [2]
(4) The grantor sells assets to the trust that are expected to increase rapidly in value and takes back an installment note. [3]
(5) The interest rate on the note is set at the lowest rate allowed under the tax law.
(6) If the total return on the assets sold to the trust exceeds the interest rate on the note, assets are transferred tax-free to the trust beneficiaries.
(7) The transfer tax benefits of the sale are enhanced by making the trust a grantor trust for income tax purposes.
(8) As a result of grantor trust status, the grantor: (a) recognizes no gain or loss on the sale, [4] (b) is not taxed on the interest payments received from the trust; [5] (c) recognizes no capital gain if payments are made in-kind; [6] (d) can make additional tax-free transfers to the remainder beneficiaries by paying the tax due on the trust income, [7] and (e) makes the trust an eligible S corporation shareholder. [8]
(9) If the trust is properly structured, none of the trust assets are included in the grantor's gross estate at death.

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