Keeping Wealth in the Family: The Fundamentals of Dynasty Trusts

~ Elizabeth P. Diaz

While every estate plan is unique, one commonality is that the IRS is never named as a beneficiary. However, without proper tax planning, the IRS can often become a beneficiary, as the federal transfer tax system imposes a tax, the estate and gift tax, each time wealth is transferred to the next generation, e.g., from parents to children, and then again, from children to grandchildren. Moreover, an additional tax, the generation-skipping transfer tax, is imposed if the transferor transfers wealth directly to a more remote generation, e.g., from parents directly to grandchildren. Accordingly, with the federal estate and gift tax rates currently being 40 percent and the federal generation-skipping transfer tax rate currently being an additional 40 percent, the IRS can have a dramatic impact on the amount of wealth that is transferred from generation to generation. A powerful estate planning technique that you can use to protect and preserve your wealth—not only from the IRS, but also from potential lawsuits, divorce, creditors, and spendthrift beneficiaries—is a type of generation-skipping transfer (GST) trust, also known as a dynasty trust. This article intends to give you a general overview of the who, what, when, why, where, and how of dynasty trusts.

Who

Dynasty trusts can play an important role for families that want a long-lasting estate planning tool that minimizes federal transfer taxes and maximizes wealth for their families.

What

A dynasty trust, in general, is a long-term, irrevocable trust that is created to transfer wealth from generation to generation, with minimal exposure to the federal transfer tax system. Typically, the grantor creates a trust for the benefit of his or her descendants, transfers assets to the trust (either during lifetime or at death), and allocates part of his or her federal estate and gift tax exemption (currently $5.49 million in 2017) and GST tax exemption (also currently $5.49 million in 2017) to the trust to shelter it from tax. Since the grantor's GST tax exemption is allocated to the dynasty trust, the assets of the trust (and all future appreciation and retained income) are generally free from federal transfer tax as the assets pass from generation to generation for the duration of the trust's life.

When

While a dynasty trust can be created either during lifetime or at death, the benefits are greatest if you create and fund it during your lifetime. This is because lifetime gifts take advantage of the "tax exclusive" nature of the gift tax. The gift tax due is based upon the amount of the gift received by the recipient. Accordingly, the amount of gift tax paid is not itself subject to tax, which is why the gift tax is referred to as being "tax exclusive." In contrast, a transfer made at death is generally subject to the estate tax, meaning that the funds used to pay the estate tax are themselves subject to tax. This is because your entire gross estate is subject to the estate tax, including assets that are ultimately going to the IRS in the form of tax. Thus, the estate tax is referred to as being "tax inclusive." Besides taking advantage of the "tax exclusive" nature of the gift tax, creating and funding a dynasty trust during your lifetime also allows you to leverage your estate and gift and GST tax exemptions. To see why, let's compare the tax effects for a grandchild in the following examples.

Why

With No Tax Planning. Here's what happens when there's a gift from Parent to Child, without any tax planning: Parent has worked extremely hard and amassed $5 million. Over the years, Parent invests the $5 million and is able to grow the $5 million to $25 million by the time of death. At death, Parent leaves all of Parent's assets to Child, outright and free of trust. Parent has $5 million of exemption to shelter $5 million of the $25 million of assets from the federal estate tax, leaving $20 million subject to tax. Accordingly, the IRS effectively becomes a beneficiary of $8 million, leaving only $17 million for Child.

Carrying the transfer of wealth one step further, here is what happens when Child passes wealth on to Grandchild: Child is not as successful with investments as Parent but is able to preserve the $17 million until death. At death, Child leaves all of Child's assets to Grandchild, outright and free of trust. Child also has $5 million of exemption to shelter $5 million of the $17 million of assets from the federal estate tax, leaving $12 million subject to tax. Accordingly, the IRS effectively becomes a beneficiary of $4.8 million, leaving only $12.2 million for Grandchild.

You can see that after only two generational transfers, the IRS became a beneficiary of more than half of Parent's original $25 million, or $12.8 million. (NOTE: Because of the GST tax, a similar result would occur if Parent created a testamentary dynasty trust and allocated $5 million of GST tax exemption to the trust at death. However, the $5 million [and all future appreciation and retained income] would be free to grow and be transferred from generation to generation without any further exposure to the federal transfer tax system.)

Tax Planning Including a Lifetime Dynasty Trust. Let's consider the same facts as above, except that Parent creates a lifetime dynasty trust. The trust provides for Child during Child's lifetime, and upon Child's death, the assets remain in trust for the benefit of Grandchild and future generations. Parent contributes the $5 million to the trust and allocates $5 million of Parent's gift tax exemption and $5 million of Parent's GST tax exemption to the trust. At Parent's death, the trust is worth $25 million. However, because Parent has not retained any interest in the dynasty trust, the trust is not included in Parent's gross estate and is not subject to the federal estate tax; and because Parent allocated $5 million of Parent's GST tax exemption to the trust, the trust is not subject to any further taxation from the federal transfer tax system. Accordingly, Parent is able to transfer the entire $25 million (and likely more, with appreciation) for the benefit of Child, Grandchild, and future generations for the lifetime of the trust, wholly disinheriting the IRS!

Where

If you decide to create a dynasty trust, among the first things you will consider are the trust's situs and governing law. Both are extremely important. In general, the trust's situs is the trust's principal place of administration. Each state has a different process and a different set of rules for what it requires to administer a trust in that state. The governing law controls the interpretation and construction of the trust document itself. It also sets forth the rules regarding the legal remedies for a trust breach, the trustee's succession, any modification of the trust, and the ultimate termination of the trust. Contrary to what you might think, the trust's situs and governing law are not limited to your state of residency. Many states have made drastic changes to their trust laws in an effort to modernize the laws and attract new business to their states.

Rule Against Perpetuities. As we stated above, one of the fundamental characteristics of a dynasty trust (other than its ability to minimize the effects of the federal transfer tax system) is its duration. The duration of a dynasty trust is governed by the state's rule against perpetuities. The rule against perpetuities is derived from common law and, in general, controls how long after the transfer of the property that the property can be held in trust. Under Florida law, a dynasty trust must terminate 360 years after its creation. However, the states vary widely on the rule against perpetuities, with some states completely abolishing the rule against perpetuities (meaning the trust can go on in perpetuity), some states requiring the termination of trusts after 1,000 years, and others requiring the termination as early as 90 years after their creation.

State Income Tax. The rule against perpetuities isn't the only consideration you'll have when choosing the trust situs. You should also consider to what extent the trust will be subject to the state's income tax. Currently, only seven states do not have a state income tax for trusts. They are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. (However, New Hampshire and Tennessee also greatly limit what is taxed at the trust level.) Of those seven "no tax" states, Alaska, Florida, Nevada, South Dakota, and Wyoming have modified the default rule against perpetuities to extend the state's rule against perpetuities to at least 360 years or more. Accordingly, if the dynasty trust is governed by the laws of one of these states, the benefits are likely to be maximized, as the trust assets are not only free from federal transfer tax but also free from state income tax, allowing them to continue to grow. (NOTE: The taxation of a trust for state income tax purposes can change, depending on the residency of the trustee.)

Asset Protection. Of more importance to preserving the assets of the trust than the state income tax is choosing a state with strong asset protection laws. While the effectiveness will largely depend on the terms of the trust, adding a spendthrift clause and a trustee's withholding clause can work to limit or completely prevent a beneficiary's creditors (including ex-spouses and litigators) or a spendthrift beneficiary from dwindling the trust assets, as long as the assets remain in the trust. However, some states' asset protection laws have diminished the protections that are afforded to the beneficiaries by creating exceptions for certain types of creditors. Historically, Alaska, Delaware, Nevada, and Utah have had the strongest asset protection trust laws. To date, Florida has not enacted specific asset protection trust laws. However, a properly drafted Florida trust does provide significant protection of assets if the trust was created by someone other than the debtor, if the assets remain in trust, and if the debtor is not given control over the assets. You can see why understanding the state's asset protection laws is a key component when you create a dynasty trust.

Modification Laws. Finally, because we do not have a crystal ball, it is impossible to know what the future holds and what circumstances your beneficiaries may face. That being the case, it is also important to look at the state's trust modification and decanting laws to determine what flexibility, if any, the trust and its beneficiaries might have to adapt to future circumstances. In Florida, upon unanimous consent of the trustee and qualified beneficiaries, it may be permissible to modify an irrevocable trust without a court order. Therefore, if the purposes of the trust have been fulfilled, or if they have become illegal, impossible, wasteful, or impractical to fulfill, or if because of unanticipated circumstances, compliance with the terms of the trust would defeat a material purpose of the trust, the trustee and qualified beneficiaries can modify the trust to account for the changes. Similarly, Florida law allows the trustee to decant a trust (meaning to "pour" the assets of the old trust into a new trust) under certain circumstances. Since not every state allows nonjudicial modification and decanting, you will want to understand what relief, if any, is available to the beneficiaries when choosing the situs and governing law for your trust.

How

While wealth preservation is fundamental to a dynasty trust, you must also consider your legacy. As the dynasty trust will hopefully be in existence for generations, reviewing your family's key values and ultimate goals is critical to determining your legacy and the ultimate purpose of the trust. With a clear vision of the trust's purpose, you can choose a trust model that will help determine how to carry out your legacy. The following are a few examples of dynasty trust models.

- *The "Support" Model.* The "Support" model is likely the most common dynasty trust model used. Under this model, distributions from the trust can be made for a beneficiary's health, support, maintenance, and education. While the trust would not permit a beneficiary to receive a distribution to purchase a brand new Ferrari, the trust would provide for the beneficiary's needs in his or her accustomed standard of living.

- *The "Safety Net" Model.* The "Safety Net" model works well if you want to ensure that your descendants will never have to empty their savings due to a large expense. Under this model, trust distributions to beneficiaries will be very limited and will be "need-based," meaning that your family members will only receive distributions for specific purposes, such as major medical expenses, milestone moments like the expenses of a wedding or the purchase of a home, catastrophic damages, and the like. The beneficiaries can even be required to submit their personal financial statements to the trustee so that the trustee can determine if the beneficiary truly has a need. Under this model, the primary goal is to grow the trust, while still providing beneficiaries with a safety net.

- *The "Incentive" Model.* The "Incentive" model works well for those families that have independently created their wealth and want to instill in their children and lineal descendants the value of hard work. Under this model, the terms of the trust would provide distributions based upon achievement and productivity but not provide full support. For example, you may provide that the beneficiary should receive a distribution for starting a business, completing a certain level of education, receiving honors, pursuing a certain career, and the like. You can even provide distributions from the trust that match the income reported on a beneficiary's Form W-2, Wage and Tax Statement.

- *The "Philanthropic" Model.* The "Philanthropic" model encourages beneficiaries to pursue meaningful, though low-paying, jobs like social work and to lead charitable organizations. Under this model, distributions can be made to supplement the low-paying wages or to mandate a certain percentage of the beneficiaries' charitable giving each year. This model can be paired with a charitable lead trust, which pays a certain percentage to charity each year for a term you select, with the remaining balance of the assets passing to the dynasty trust upon the expiration of the term. As you are entitled to a federal gift tax deduction for the present value of the charitable lead trust, this can be another way to leverage your exemptions.

- *The "Family Business" Model.* The "Family Business" model can be used to preserve your family business and plan for its succession. This model would typically be used in conjunction with other estate planning techniques as part of a comprehensive business succession plan. However, in general, under this model, you would transfer a portion of your interest in the family business to the trust (or trusts if you wish to create one for each of your children).

While creating a dynasty trust may seem complex, it can be a powerful estate planning tool, not only to protect your wealth from the IRS and other unintended beneficiaries, but to preserve it for the use of your future generations, ensuring your legacy will continue for generations to come.

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