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White Paper:
Dynasty Trust

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Dynasty Trust

What is it?

A dynasty trust is an irrevocable trust that is designed to last as long as legally possible. The purpose of the trust is to pass the assets in the trust through as many generations as possible without imposing any transfer taxes (gift, estate, or generation-skipping taxes) on the property in the trust. In addition to avoiding transfer taxes, a dynasty trust may help to protect the assets against attachment by creditors or unhappy spouses of the beneficiaries. Most states have a legal restriction on the life of a trust, called the Rule Against Perpetuities. This rule means that a trust cannot be drafted to last indefinitely. The trust must terminate and distribute assets no later than 21 years after the death of any individual alive at the time of the creation of the trust who is named in the trust as a "measuring life." Thus, if you make your grandchild a beneficiary, the trust must end no later than 21 years after his or her death. Certain states have eliminated the rule against perpetuities. In these states, a trust can be set up to last forever. Typically, very wealthy families have used dynasty trusts to maintain their wealth through multiple generations. Once the trust has been funded, the trustee (usually a corporate trustee) is given broad powers to distribute income or principal to the beneficiaries. The generation-skipping transfer tax (GSTT) has curtailed somewhat the use of dynasty trusts in estate planning. However, with careful drafting, a dynasty trust may still be an effective planning device for certain wealthy individuals.

When can it be used?

Dynasty trust should only be used when you want to preserve assets for more than one generation

A dynasty trust makes sense only for people who want to preserve their assets for two or more generations. A dynasty trust is usually drafted to last as long as legally possible. If you have no interest in providing for your grandchildren (or great-grandchildren), then there is no need to set up a dynasty trust.

Dynasty trust should be used only by very wealthy individuals

In almost all cases, only very wealthy individuals should consider setting up a dynasty trust. You should have sufficient assets so that you can provide not only for your direct heirs (usually your children) but also for multiple generations after your children.

Example(s): Say you own a small privately held company. You expect that your taxable estate will be in the range of \$2 million to \$3 million. You have three children and four grandchildren. Your children are very responsible with money. With an estate this size, it probably does not make sense to create a dynasty trust.

Dynasty trust must be set up as an irrevocable trust

A dynasty trust should be set up as an irrevocable trust. A trust is considered irrevocable if you do not have the right to amend or revoke the trust.

Gift tax may have to be paid on transfers into dynasty trust

Because dynasty trusts are always set up as irrevocable trusts (to avoid estate taxation), any transfer of assets into the trust may be subject to gift taxation. There are two main exemptions to the gift tax. First, everyone is given a gift tax applicable exclusion amount (formerly known as the unified credit), which exempts the first \$1 million of gifts. Second, there is an annual gift tax exclusion of \$13,000 (2009 figure, up from \$12,000 in 2008) per donee (or \$26,000 per donee if the gift is split with your spouse). In other words, you can make gifts of \$13,000 in 2009 to an unlimited number of individuals without being subject to federal gift tax. It becomes a little complicated when a gift is made to a trust. To qualify for the annual gift tax exclusion, the gift must be a present interest gift (i.e., the recipient of the gift must be able to presently enjoy and use the gift). If the gift is made to the trust and the beneficiaries of the trust do not have the immediate right to use the gift, then the annual gift tax exclusion does not apply. To get around this problem, estate planning attorneys give the beneficiaries of the trust Crummey powers (named after a famous tax court case). A Crummey power gives the beneficiary the right to withdraw the money from the trust as soon as the grantor makes the transfer. The gift will then qualify for the annual gift tax exclusion. In most cases, the beneficiaries will not actually withdraw the money, and the trustee can then use the money in accordance with the wishes of the grantor.

Caution: Keep in mind that the applicable exclusion amount for gift tax purposes is \$1 million even though the applicable exclusion amount for estate tax purposes is \$3.5 million in 2009. Any portion of the gift tax applicable exclusion amount you use during life will effectively reduce your estate tax applicable exclusion amount that will be available at your death.

Independent trustee should be named for trust

In most cases, an independent trustee should be named for the dynasty trust. Because the trust is designed to last as long as possible, many estate planners recommend that a corporate trustee (a bank trust department or an independent trust company) be used. The rationale is that you want a trustee that can administer the trust for its entire existence. In some situations, you (the creator of the trust) may want to name yourself as the trustee. However, if you name yourself as the trustee, you must be extremely careful to limit your powers over the trust. For example, your power to make discretionary distributions from the trust should be limited to "ascertainable standards."

Example(s): Say you have accumulated substantial assets over your lifetime. You have two children and six grandchildren. You would like to set up a dynasty trust to preserve as much of your wealth as possible for your children and grandchildren. In most cases, because the trust will last for more than one generation, you should name either a bank trust department or an independent trust company to be the trustee of the trust.

Dynasty trust may be created during grantor's lifetime or at grantor's death

A dynasty trust may be created either during your lifetime or at your death (a testamentary dynasty trust). If the trust is created at your death, then the assets transferred to the trust will be included in your taxable estate. You may use the estate tax applicable exclusion amount (which shelters up to \$3.5 million in 2009) to avoid federal estate taxes on some or all the assets passed into the testamentary dynasty trust. The testamentary trust can also be drafted to qualify for the unlimited marital deduction. In other words, the trust will pass to your spouse free of estate taxes. However, when your spouse dies, the dynasty trust will then be subject to estate taxes in his or her estate. Although a dynasty trust may be created at your death, many estate planners recommend that you set up and fund a dynasty trust during your lifetime. This is because the subsequent appreciation in value is removed from your estate, and because any gift taxes that may have to be paid will be subtracted from your taxable estate if you live for more than three years after the gift.

Example(s): Say you would like to set up a dynasty trust, but you are not sure if you want to create it during your lifetime or at your death (through your will). One factor to consider is that if you transfer assets into the trust during your lifetime, any gift taxes that you pay will be deducted from your taxable estate.

Caution: If you die within three years of the gift, then any gift taxes that you have paid are added back into your taxable estate. However, if you wait to create a dynasty trust in your will, then the full value of the assets will be included in your taxable estate. Your heirs will then have to pay estate taxes from what remains of your assets. They cannot deduct the estate taxes paid from the value of your taxable estate.

Generation-skipping transfer tax (GSTT) may be incurred when trust has beneficiaries two or more generations below grantor

If the dynasty trust has beneficiaries two or more generations below you, then the generation-skipping transfer tax (GSTT) may apply whenever a transfer is made to those individuals. The tax is currently equal to the highest marginal gift and estate tax (45 percent in 2008). Each individual is given an exemption from the GSTT (\$3.5 million in 2009). Thus, you can give away up to \$3.5 million to individuals two or more generations below you without incurring the GSTT. A husband and wife could give away up to \$7 million. The imposition of the GSTT has limited the use of dynasty trusts by wealthy families.

Example(s): Say you set up a dynasty trust and name your children and grandchildren as the beneficiaries of the trust. You transfer assets to the trust. One year later, the trustee distributes income from the trust to all of the beneficiaries, including the grandchildren. The distribution to the grandchildren is considered a transfer to a skip person. The GSTT will apply to this distribution. If available, you could use the exemption to avoid the imposition of the GSTT. If the exemption has been fully utilized previously, then you will have to pay the GSTT on the distribution.

Tip: For tax years after 2003, the GSTT exemption is the same amount as the gift and estate tax exemption.

Strengths

Dynasty trust may be used to pass assets through multiple generations

A dynasty trust may be an appropriate vehicle for a very wealthy individual to use to assure the transfer of assets through multiple generations (to create a dynasty, in a sense). A dynasty trust is usually drafted to last as long as legally possible. In most states, the rule against perpetuities requires that trusts terminate no later than 21 years after the death of the last beneficiary alive when the trust became irrevocable. The trust may exist then for 60, 70, 80, or even more years. In those states where the rule against perpetuities has been abolished, trusts may be set up to last forever.

Dynasty trust may be used to preserve wealth through avoidance of transfer taxes

Another benefit to a dynasty trust is that the assets may avoid all transfer taxes (gift, estate, and GSTTs) for the life of the trust. If the dynasty trust is drafted properly, the assets in the trust could pass through multiple generations without being subject to transfer taxes at each generation. In this manner, the assets could multiply substantially over the entire term of the trust.

Example(s): Say you and your wife set up a dynasty trust and fund the trust with \$1 million. You have three children and six grandchildren. At the time the trust is created, the youngest grandchild has a life expectancy of 60 years, making the expected longevity of the trust 81 years. Assuming that the money will compound at an after tax rate of 6 percent per year and that no funds will be paid out during the term of the trust, the funds in the trust will grow to approximately \$112 million by the time the trust ends. The dynasty trust in this example offers significant growth potential by eliminating transfer taxes on one generation of wealth transfers.

Dynasty trust may be used to protect assets in trust against creditors and unhappy spouses of beneficiaries

Because the dynasty trust is set up as an irrevocable trust, the assets in the trust are protected against creditors and spouses (in a divorce) of the beneficiaries. A creditor of the beneficiary will not be able to attach the assets in the trust. Similarly, a spouse of the beneficiary will not be entitled to any of the assets in a divorce proceeding. If you are concerned about preserving your wealth for your lineal descendants, a dynasty trust can be an excellent way to protect the assets through multiple generations.

Grantor may have considerable flexibility in how dynasty trust will be set up

A dynasty trust can be flexibly designed to provide interests and benefits to each generation while avoiding transfer taxes. The grantor (the individual who originally sets up the trust) can draft the trust so

that each beneficiary can have interests in and control over the trust without having the assets in the trust taxed at his or her death. The trust could be drafted so that the beneficiaries could have an income interest in the trust (in other words, receive annual distributions from the trust). The beneficiaries could be given the power to withdraw money from the trust for their health, education, support, or maintenance. The beneficiaries could be given a limited power of appointment to give trust property to anyone other than the beneficiary himself, the beneficiary's estate, or the creditors of the beneficiary. The trustee could be given the power to distribute the trust assets to the beneficiaries. Thus, you have a great deal of flexibility in how you want the trust to operate for the benefit of the beneficiaries without exposing the assets to transfer taxes. In a sense, a dynasty trust gives you the power to control and to preserve the assets for a period of time long after your own death.

Dynasty trust may qualify for unlimited marital deduction

A dynasty trust may be created to qualify for the unlimited marital deduction. With careful drafting, you can set up the trust so that upon your death the trust will pass free of estate taxes to your spouse. The assets may then be taxed upon your spouse's death, but you will have delayed the imposition of the estate taxes. Furthermore, many people use both a dynasty trust and a qualified terminal interest property (QTIP) trust to take advantage of both the federal applicable exclusion amount and the GSTT exemption amount. A QTIP trust qualifies for the unlimited marital deduction, allows your spouse to receive income for life, and then passes the assets to your heirs upon your spouse's death.

Example(s): Say you have an estate of \$7 million. You set up one trust of \$3.5 million in 2009 and use the applicable exclusion amount to shelter this trust from the estate tax. You then leave a QTIP trust to your spouse with the other \$3.5 million. Your taxable estate for federal estate tax purposes will be zero. Your grandchildren are the sole beneficiaries of the trusts and thus the GSTT will apply if you do not use the GSTT exemption given to both you and your spouse. The executor of your estate then allocates your \$3.5 million GSTT exemption to the first trust. Your spouse's GSTT exemption can then be used to shelter the assets in the QTIP trust from the GSTT. Thus, your entire \$7 million will escape the GSTT.

Caution: This may not be the proper strategy for some married couples. A tax law passed in 2001 replaced the state death credit with a deduction starting in 2005. As a result, many of the states that imposed a death tax equal to the credit, decoupled their tax systems, imposing a stand-alone death tax. Many of these states allow an exemption that is less than the federal exemption. This may leave some couples vulnerable to higher state death taxation. See your financial professional for more information.

Life insurance may be used in dynasty trust

In many dynasty trusts, the grantor will try to leverage both the applicable exclusion amount and GSTT exemption by funding the trust with a life insurance policy. An existing policy may be transferred to the trust, or the grantor may make cash gifts to the trust then have the trustee purchase a life insurance policy on the grantor's life.

Tradeoffs

Dynasty trust must be set up as irrevocable trust

To remove the assets in the trust from your taxable estate, a dynasty trust must be drafted as an irrevocable trust. Therefore, you will lose control over the assets once they have been transferred into the trust.

Transfers into dynasty trust may be subject to gift tax

Because the dynasty trust must be drafted as an irrevocable trust, any transfer of property into the trust may be subject to gift tax. With careful drafting, transfers into the trust may qualify for the annual gift tax exclusion. The annual exclusion gifts may be made for each beneficiary of the trust. You may also utilize the gift tax applicable exclusion amount to cover any gift tax that may be due on transfers into the trust.

Example(s): Say you set up a dynasty trust and name your three children and four grandchildren as the beneficiaries of the trust. You transfer \$1 million into the trust. You have completely depleted the applicable exclusion amount with previous gifts to your children and grandchildren. The entire \$1 million is then a taxable gift (unless part of the \$1 million transfer qualifies for the annual gift tax exclusion). You would then have to pay the applicable gift tax.

Tip: If the trust were drafted properly, any future appreciation in the assets would not be taxed at either your death or the death of the beneficiaries.

Transfers into dynasty trust may be subject to GSTT

Another tradeoff to a dynasty trust is that the trust may be subject to the GSTT if the beneficiaries are two or more generations below the grantor. There are a variety of ways that a generation-skipping transfer may occur in a dynasty trust. If all the trust beneficiaries are skip persons (two generations or more below the grantor), then any transfer to the trust may be subject to the GSTT. Another type of transfer occurs when an interest in the trust terminates and that interest passes to a skip person. A third type of generation-skipping transfer occurs when there is an actual distribution from the trust to a skip person. The GSTT rate is 45 percent in 2009. As noted, each individual is given a \$3.5 million lifetime exemption from the GSTT in 2009. Therefore, a husband and wife could give up to \$7 million in those years without incurring the GSTT.

Dynasty trust may be expensive to set up

You will need to hire and pay for an experienced attorney to advise you on the tax and estate planning issues and to draft the dynasty trust. In most cases, you will also want to hire a corporate trustee (a bank trust department or private trust company) for the dynasty trust. These types of corporate trustees will usually charge an annual fee for their services based on the size of the assets in the trust.

How to do it

Hire competent, experienced legal counsel

You need to hire a competent and experienced estate planning attorney to draft the dynasty trust. There are many complicated tax and legal issues that need to be addressed when setting up this type of trust. You should also coordinate the dynasty trust with your overall estate plan. In most cases, you should only use a dynasty trust if you have very substantial assets. A dynasty trust usually only makes sense if you have enough assets to provide for your immediate heirs (usually your children) and your secondary heirs (your grandchildren and great-grandchildren).

Corporate trustee must be selected

In most cases, you will want to appoint a corporate trustee (usually a bank trust department or private trust company) for the dynasty trust. Because a dynasty trust is designed to last as long as legally possible, you will want a trustee who will be in existence as long as the trust. This will usually preclude using an individual as the trustee.

Beneficiaries must be selected for trust

You must decide who the beneficiaries of the trust will be. Typically, you will name your children, grandchildren, and even great-grandchildren (if you have any) as the beneficiaries of the trust. The purpose of a dynasty trust is to preserve your wealth for as many generations as possible. There are some situations where you may want to skip one generation and name only your grandchildren and great-grandchildren (if alive) as the beneficiaries of the trust. These are the types of decisions that should be discussed with your estate planning attorney.

Tax considerations

Income Tax

Grantor may be taxed on trust income under grantor trust rules

If you retain an interest in or control over the dynasty trust, you may be taxed on any income that the trust generates. The rules involving the taxation of grantor trusts are extremely complicated. In most cases, you will not want to be taxed on trust income. However, there are some situations where it may make tax sense to have the grantor taxed on income from the trust. Therefore, you will want to create an intentionally defective grantor trust in which the grantor is taxed on the trust income. You, therefore, need to be extremely careful about how the trust is drafted. You should hire an experienced and competent estate planning attorney to draft the dynasty trust.

Person other than grantor may be treated as owner of trust if that person has power to appoint trust corpus or income to himself or herself If a person other than the grantor of the dynasty trust has the

power to appoint trust corpus or income to himself or herself, then that person will be treated as the owner of the trust. Income from the trust will then be taxed to that person. Again, this is an extremely complicated area. A tax or estate planning attorney should be consulted on the income tax consequences.

Beneficiary may be taxed on income received from trust

A beneficiary may be taxed on income received from the trust. If the trust income is distributed to the beneficiary, then the beneficiary will be taxed on that income. If the trust retains the income, then the trust itself will be taxed on the income.

Gift Tax

Transfers to dynasty trust may be subject to gift tax

Because a dynasty trust is set up as an irrevocable trust, any transfers into the trust will be subject to the gift tax. If the transfer qualifies as a present interest gift to the beneficiary, then the \$13,000 (2009 figure, up from \$12,000 in 2008) annual gift tax exclusion (\$26,000 if split with your spouse) per donee is available. If the beneficiaries do not have a present interest in the gift (they do not have the right to presently use and enjoy the transfer into the trust), then the annual exclusion will not apply. To avoid this annual exclusion problem, the beneficiaries can be given Crummey withdrawal powers allowing them to withdraw any transfer made to the trust during a specified period of time. In addition to the annual gift tax exclusion, you may use the gift tax applicable exclusion amount to exempt \$1 million. If neither the annual gift tax exclusion nor the gift tax applicable exclusion amount is available, then you must pay the gift tax on any transfers to the trust.

Example(s): Say you set up a dynasty trust and transfer \$1 million into the trust. You have fully utilized the applicable exclusion amount with previous gifts. You will have to pay the gift tax on the transfer that is in excess of the annual gift tax exclusion. However, any future appreciation in these assets will not be included in your taxable estate.

If grantor's spouse is given interest in trust, then such interest may qualify for the marital deduction

If your spouse is given an interest in the dynasty trust, then that interest may qualify for the unlimited marital deduction. The types of interests that qualify for the marital deduction include an income for life with a general power of appointment trust, a QTIP trust, an estate trust, a charitable remainder trust, and a qualified domestic trust. In most cases, a QTIP trust is used for a dynasty trust. A QTIP trust allows the spouse to receive income for life with the remainder going to your heirs. The QTIP trust would be included in your spouse's taxable estate. A QTIP trust is often used because it allows each spouse to fully utilize his or her GSTT exemption from.

Estate Tax

Dynasty trust will usually not be included in the taxable estate of grantor

The assets that have been transferred into a dynasty trust during your lifetime will not be included in your taxable estate as long as you do not retain any strings over the trust. Thus, you should not retain a life interest in the trust, a reversionary interest, or any incidents of ownership in a life insurance policy held by the trust. As noted, although the assets in the dynasty trust will not be included in your taxable estate, they will be subject to the gift tax when the assets are transferred into the trust during your lifetime. If the dynasty trust is created at your death (a testamentary trust), then the assets will be included in your taxable estate.

If dynasty trust utilizes marital deduction, then assets in trust may be included in taxable estate of spouse

If your spouse were given an interest in the dynasty trust (such as a QTIP trust), then this interest would qualify for the unlimited marital deduction. The unlimited marital deduction means that you can leave an unlimited amount of assets to your spouse without incurring any estate taxes at that time. However, the assets in the trust may then be included in the taxable estate of your spouse.

Dynasty trust will generally not be included in estate of beneficiaries

A beneficiary may be given a wide variety of interests in the dynasty trust without having the assets included in the beneficiary's estate. The beneficiary could receive income from the trust. The trustee could be given the power to distribute trust assets to the beneficiary. The beneficiary could be given a withdrawal power from the trust for the health, education, support, or maintenance of the beneficiary, as well as the power to give the assets to anyone but the beneficiary himself, the beneficiary's estate, or the creditors of both. However, if the beneficiary is given a general power of appointment over the trust, then the dynasty trust will be included in his or her taxable estate.

Generation-Skipping Transfer Tax

GSTT may apply to dynasty trusts if beneficiaries are two or more generations below grantor

The GSTT was enacted to prevent untaxed transfers to individuals two or more generations below the transferor. Thus, if the dynasty trust has beneficiaries two generations below the grantor (called skip persons) and transfers are made to those beneficiaries, then the GSTT may apply to those transfers. A generation-skipping transfer can occur in a number of ways in a dynasty trust. If all of the beneficiaries of the trust are two generations or more below the grantor, then any transfer into the trust will be subject to the GSTT. If the trust terminates and a distribution is made to a skip person, the GSTT will apply. If the trustee makes a discretionary distribution to a skip person, then this transfer may be subject to the GSTT.

Grantor is given exemption from GSTT

Although the GSTT rate is 45 percent (in 2009), each individual is given an exemption from the GSTT (\$3.5 million in 2009). Thus, a husband and wife could give up to twice the GSTT exemption amount to skip persons without incurring the GSTT. This exemption may be further leveraged if the dynasty trust uses the exemption amount to purchase a life insurance policy on the grantor.

Tip: The GSTT rate is the same as the maximum estate tax rate, and, for tax years after 2003 and thereafter, the GSTT exemption is the same amount as the estate tax exemption.

Questions & Answers

When should a dynasty trust be used?

A dynasty trust should only be used by individuals who want to preserve and pass their wealth through multiple generations. Typically, only very wealthy individuals have used dynasty trusts. You should have sufficient assets to provide for your children, grandchildren, and even your great-grandchildren (if alive).

How long may a dynasty trust last?

In most states, the life of a dynasty trust is limited by the rule against perpetuities. The rule against perpetuities states that a trust must terminate and distribute its assets no later than 21 years after the death of any individual alive at the time the trust becomes irrevocable who is named in the trust as a "measuring life." Therefore, if you name your grandchildren as beneficiaries of the trust, the trust must terminate 21 years after the death of the last one to die. Certain states have eliminated the rule against perpetuities. In these states, a trust could be drafted to last forever.

Who should be named as the trustee of the dynasty trust?

In most instances, a corporate trustee (a bank trust department or an independent trust company) should be appointed as the trustee for the trust. Because the trust is designed to last as long as legally possible, you will want a trustee that will be in existence for the life of the trust. For this reason, you probably do not want to appoint an individual to be the trustee.

Will a dynasty trust avoid estate taxation upon your death?

If the trust is drafted properly, the assets in the trust should not be included in your taxable estate. A dynasty trust is usually set up as an irrevocable trust. This will preclude the assets from being taxed at your death. However, any transfers into the trust will be subject to gift tax. You may use both the applicable exclusion amount and the annual exclusion to shelter at least some of the transfers from gift tax. Furthermore, the assets in the trust should not be subject to estate taxation upon the deaths of the beneficiaries. One of the advantages of a dynasty trust is that the assets should grow without being subject to transfer taxes.

Who will be taxed on income from the trust?

If the dynasty trust is deemed to be a grantor trust, then the grantor will be taxed on income from the trust. Therefore, in many cases, you do not want the trust to be a grantor trust. If the trust distributes income to the beneficiaries (and it is not a grantor trust), then the beneficiaries will be taxed on the income. If the trust retains the income, then the trust itself will be liable for the income tax. The rules on the income taxation of trusts are extremely complicated. You should consult either a tax accountant or an estate planning attorney for any tax questions about the trust.

Can life insurance be used in a dynasty trust?

Yes. Often, a life insurance policy on the grantor will be transferred into the trust, or the trustee will purchase a new life insurance policy. This strategy can be a very effective way to leverage both the applicable exclusion amount and the GSTT exemption.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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