

Dynasty Trusts

With greater affection for their grandchildren than their children, many people create trusts that benefit their families for generations to come. Such trusts are often referred to as dynasty trusts as they are designed to benefit multiple generation of a family. Dynasty trusts are primarily designed to avoid estate tax because, so long as the property remains in trust, it is not included in the estate of any beneficiary.

The federal government realizing that estate tax revenues were being “lost” because of such trusts created the Generation Skipping Transfer (GST) tax. This is a separate tax from estate tax and gift tax and, in many cases, in addition to such taxes. In a nut shell, any property (in excess of the exclusion which will be discussed below) that passes to a generation two below the transferor is subject to a flat tax of 46% in 2006, the highest estate tax rate.

There are cumbersome rules about the generation to which a person is assigned which are well beyond the scope of this article. Generally, a person related to the transferor who is two or more generations below the transferor is a “skip person” and transfers to such person are subject to GST tax. There is an exception in the case of a deceased parent which may allow an otherwise step person to move into the first generation below the transferor. Again, this is far too detailed to address here.

In my simple example, we have grandpa, son and granddaughter. If grandpa wanted to leave everything in trust for his granddaughter, to the extent that the value of property passing to the trust exceeded the exemption amount, it would be subject to the GST tax. Fortunately, the exemption from GST tax is substantial, \$2 million through 2009. Moreover, under the current federal tax statute, the GST tax is repealed for transfers made in 2010; however, if the transfer is made in 2011, we are back to the old exemption amount of \$1 million thanks to the sunset provision in the current tax statute.

That is enough with the GST tax. This article is about dynasty trusts, but it is necessary to point out the proverbial elephant in the room (and I can avoid the question of why not drop everything you have into a dynasty trust).

The dynasty trust often allows distributions to multiple generations, but the hope of the grantor of the trust is that the trust will be allowed to grow for a long period of time. The key is that the GST tax exemption is applied to the value of the trust when funded; thus, at his death, grandpa could leave \$2 million in trust for his son, granddaughter and all other lineal descendants. If his GST tax exemption is applied to the trust, the trust could grow free from GST tax. All income could be accumulated and, if the trust had a return of 7% after tax, it would grow to almost \$60 million in fifty years. As long as the property stayed in trust, it would not be included in anyone’s estate and subject to estate tax.

Another ancillary issue to consider is that most jurisdictions prohibit trusts for non-charitable uses to continue forever. This is known as the rule against perpetuities.

There are several jurisdictions that do not have such a rule to attract people interested in such trusts, but again, the subject matter here is dynasty trusts.

I incorporate dynasty trust planning in almost every estate plan. Does every client have enough to fund the needs and desires of his/her family for generations? No, but you never know what is going to happen. The key at the planning phase is flexibility. Permit the executor to apply GST exemption to a trust of which the kids and the grandkids are beneficiaries and, if the kids do not need the money, it can benefit the grandkids and avoid GST tax. So long as you have trustees that will make the tough decisions about distributions after you are gone, your life savings may be able to benefit multiple generations. (Another related topic for discussion is how these types of trusts can be used for income tax planning purposes to minimize the overall income tax of the family.)

Others, such as everyone's favorite investor Warren Buffet, want to leave the majority of their estates to charity. The distinction seems to be in the estate amounts involved. Leaving all but \$6 billion to charity does not exactly leave the family poor. Even if invested at 5%, the income stream of \$300 million a year should be enough to scrape by on.

Dynasty trusts should be considered in most estate plans. In some cases, the particular items of property may make it inappropriate for such a trust, but, as will be discussed in further detail in next month's article, there are numerous advantages to leaving property in trust as opposed to distributing it outright to beneficiaries. You should discuss the use of dynasty trusts with your estate planning attorney.

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