Dynasty Trusts

One of the most common and essential estate planning techniques involves creating a trust that is designed to last for more than one generation – a "dynasty" trust. In addition to allowing the donor to impose controls on the gifted assets for a long period of time, a carefully constructed dynasty trust will also minimize the imposition of transfer taxes on the family as a whole.

Duration of Trust

In Texas, as in most states, an individual cannot create a perpetual non-charitable trust, but a dynasty trust can practically continue to exist for an extensive period of time. Some states, such as Texas, limit the maximum term of a dynasty trust to a period measured by the lives of individuals who are living at the time the dynasty trust is created or otherwise becomes irrevocable. Other states use a fixed period of time set by statute (e.g., 199 years). The state statute dealing with the durational limits of dynasty trusts is usually referred to as the "Rule Against Perpetuities." A few states have recently repealed their Rules Against Perpetuities, and now, at least in theory, allow the creation of perpetual, non-charitable trusts. However, those states have also imposed many conditions and legal requirements on the creation of such trusts in their jurisdictions, thus diminishing the net benefits to persons who are not residents. Nevertheless, if an individual wants to create a perpetual, non-charitable trust for his or her family, then the creation of the dynasty trust in or under the laws of one of those states should be considered.

Structure of a Dynasty Trust

To establish a dynasty trust, a donor executes a written trust agreement or incorporates such provisions into a will and designates a trustee to hold the trust assets. The dynasty trust is typically structured to last for the lifetimes of the donor's children, and then, the lifetimes of the donor's grandchildren and more remote descendants. . The perpetuities period in this type of trust can be tied to a well-known family with many members and young children, such as the Kennedys, so that the trust is likely to last for 90 to 100 hundred years. When the trusts finally terminate, the assets are distributed to the donor's descendants who are then living.

A dynasty trust can be –formulated as either a pot trust or as separate trusts. A "pot" trust is one trust in which all of the donor's living children or descendants are beneficiaries. The trustee is given discretion to "sprinkle" or "spray" distributions among the various beneficiaries in amounts that are not necessarily equal. A pot trust simplifies administration but may make it difficult for the trustee to decide how to make distributions and to whom. To avoid entwining the beneficiaries' financial affairs (particularly if they are geographically diverse), the donor may create separate trusts for each child or descendant, ensuring an equality of treatment. Or a combination of a pot trust and separate trusts could be used in recognition of the divergent ages and lifetime benefits already received by a class of beneficiaries, whereby a pot trust is established for the benefit of children until the youngest attains a certain age (for example, old enough to have graduated from college), upon which the trust is then divided into separate equal trusts for each child.

Control of Trust Assets

As stated above, a dynasty trust allows the donor to effectively regulate the disposition of the trust's assets for a long period of time. Through the structure of the trust, the donor may either dictate the timing, conditions, and beneficiaries of trust distributions or give the trustee complete discretion as to when and if distributions should be made. By providing that the donor's descendants are the only permissible beneficiaries, the donor essentially keeps the trust assets within the family for many generations. This goal is furthered by structuring the trust to protect the trust assets from the beneficiaries' creditors (including divorcing spouses). Finally, through the selection of the trustee, the donor can ensure that the assets are professionally managed.

Transfer Tax Benefits

A common reason to use dynasty trusts is for the donor to take advantage of his or her exemption from generation-skipping transfer ("GST") tax. The GST tax is a transfer tax - in addition to the estate tax - that is imposed at the highest estate tax rate on transfers that skip a generation. (For example, a generation skip occurs if a donor transfers property directly, or through a trust, to the donor's grandchildren while the donor's child, who is the parent of the grandchildren, is living.) The purpose of this tax is to prevent the avoidance of a layer estate tax at the "skipped" generation. That is, in the absence of the GST tax, each generation of donors could leave property directly or indirectly to their grandchildren, and as such,avoid estate tax imposed upon their children's generation.

As indicated previously, each person has an exemption from the GST tax. The exemption amount for the year 20120 is $10,580,000 and is scheduled to increase annually for inflation; but without further statutory changes, the GST exemption amount is scheduled to decrease by half in 2026. These increases track the estate tax applicable exclusion amount so that the amount of property that can be transferred free of the GST tax will equal the amount of property that can also pass free of the federal estate tax. As part of an estate plan, a donor could make a gift during his or her lifetime of the GST tax exemption amount to be held in a dynasty trust. The assets in the trust would be available for the benefit of the donor's descendants, without being subject to GST or estate tax in any of their estates. If the donor's children will receive additional assets from the donor at his or her death, then the amount that passes to the dynasty trust can be viewed as a nest egg , which is accessible if necessary, but would otherwise pass to succeeding generations free of transfer tax.

Timing

A dynasty trust can be implemented at the donor's death, but it is most beneficial when established during the donor's lifetime. Part of the reason for this benefit is that while gift taxes are assessed on the value of the property gifted and are paid separately by the donor, estate taxes are assessed on the value of the entire estate and paid by the estate itself (meaning that the taxable estate includes the amount that will be used to pay the estate tax)

Another more practical benefit of making a lifetime gift is that all future appreciation on the property escapes transfer taxation. For example, suppose a donor wanted to make a gift of real property worth $1,000,000. By making the gift today, the donor would pay transfer tax on $1,000,000. If, on the other hand, the donor decided to wait until the donor's death to make the gift and the property had appreciated to $2,000,000, then the donor's estate would pay transfer tax on the property's appreciated value of $2,000,000.

Leveraging with Insurance

Finally, another idea is for a donor to use all or part of the GST tax exemption to purchase a life insurance policy payable upon the donor's death. This is often an excellent way to leverage the GST exemption because the gift of the exemption amount will, upon the donor's death, produce significant proceeds for the dynasty trust to pass free of GST and estate taxes until the dynasty trust terminates many years later. The use of private placement life insurance ("PPLI"), in particular, may also offer cost savings with respect to larger policies and income tax savings versus the use of other forms of investments assets.

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