Dynasty Trusts

A common estate planning technique is to create a trust that is designed to last for more than one generation – a "dynasty" trust. Its two primary benefits are that it minimizes the transfer taxes on the assets of the family as a whole and that it allows the donor to impose controls on the gifted assets for a long period of time.

Duration of Trust

Currently in Texas, as in most states, an individual cannot create a perpetual, non-charitable trust, but the dynasty trust can be continued for an extensive period of time (approximately 100 years or more). Some states, such as Texas, limit the maximum term of a dynasty trust to a period measured by the lives of individuals 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 A few states have recently repealed their Rules Against Perpetuities, and now, in theory, those states allow the creation of perpetual, non-charitable trusts by individuals. However, those states have imposed many conditions and legal requirements on the creation of such trusts in their jurisdictions, making the actual creation of such trusts by non-residents less attractive. 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 creates a trust and designates a trustee to hold the trust assets. The trust is typically structured to last for the lifetimes of the donor's children, and then continuing trusts hold the assets for the lifetimes of the donor's grandchildren and more remote descendants. In Texas, the trusts ultimately terminate upon the expiration of the common law "perpetuities" period, which is 21 years after the death of the last surviving "life in being" at the time of the trust's creation. We usually tie the perpetuities period in this type of trust to a well-known family with many members and young children, such as the Kennedys, so that the trust or trusts can last for at least 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 structured in one of two ways - as a pot trust or as separate trusts. A "pot" trust is one trust in which all of the donor's descendants living from time to time 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 could instead create separate trusts. For example, the donor might create a separate trust for each of the donor's children. Each child's descendants may also be beneficiaries of that child's trust. This trust could terminate at the child's death, at which time the assets would pass to separate trusts for each of the child's children (the donor's grandchildren).

Control of Trust Assets

As stated above, a dynasty trust allows the donor to control 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 distributions, if any, 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 estate tax at the "skipped" generation. That is, in the absence of the GST tax, donors could leave property directly to their grandchildren, and that property would avoid estate tax at their children's generation.

As indicated previously, each person has an exemption from the GST tax. The exemption amount for the year 2016 is $5,450,000 and is scheduled to increase annually for inflation. 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 one or more dynasty trusts. The assets in the trust(s) 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(s) can be viewed as a "nest egg" accessible if necessary, but otherwise passing to succeeding generations free of transfer tax.

For example, if a donor made a $1,000,000 gift to a dynasty trust during lifetime, he or she would pay gift taxes of $0 to $470,000 (depending on the amount of prior taxable gifts made during lifetime). The donor would also file a gift tax return allocating his or her GST tax exemption to this gift. The trust assets would thereafter pass from generation to generation free of transfer tax until they are distributed outright (after approximately 100 years) and taxed in the estates of the recipient beneficiaries. If one assumes a fairly conservative growth rate of 4% per year net of income tax and limited distributions, there would be over $50,000,000 in the trust at the end of the 100 year period.

Timing

A dynasty trust can be implemented at the donor's death, but it is most beneficial when established during the donor's lifetime because of the manner in which transfer taxes are levied on lifetime transfers versus transfers at death. Another 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. For these reasons, donors are encouraged to make lifetime gifts, if possible.

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, if at all.

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