

Leimberg's Think About It

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DYNASTY TRUSTS

This commentary on Dynasty Trusts is based on chapters from my books, [The Cutting Edge](#) (610-924-0515), [The Tools And Techniques Of Estate Planning](#) (800-543-0874), [The Book Of Trusts](#) (610-924-0515), and [Tax Planning With Life Insurance](#) (800-950-1216).

DYNASTY TRUST DEFINED

A dynasty trust (also called a "megatrust") is a special type of irrevocable life insurance trust (ILIT) which, if designed and administered properly, can be thought of as an ILIT on (legal) steroids; i.e., it can maximize the grantor's generation-skipping transfer (GST) exemption and enable massive amounts of wealth to remain within a family unit.

There are two key distinctions between the traditional ILIT and the dynasty trust:

First, most ILITs are typically designed to benefit two or three generations of individuals. For example, trust provisions usually give the trustee sole discretion to "sprinkle" income and "spray" capital to and among intended beneficiaries. These provisions also provide for withdrawal powers (limited by ascertainable standards) to provide for the grantor's spouse for life, then his/her children for life and, finally, the remainder will pass to the grantor's grandchildren, after which the trust is terminated. The dynasty trust, rather than requiring distributions of assets to future generations, is deliberately designed to continue for as long as legally permissible under the state law where it is legally located (situs).

Second, in the classic ILIT, trust assets are usually distributed entirely by the time it reaches the grantor's grandchildren's level. Conversely, assets in a dynasty trust are available to trust beneficiaries (they can receive trust income, and have use of the asset) but the dynasty trust does not provide them with actual outright ownership of the assets.

This second distinction achieves the primary objective of a dynasty trust: keeping huge amounts of wealth in a family for as long as state law limits allow, and at the same time shielding the trust

assets from federal estate and generation-skipping transfer taxes as the income from, and use of the property move from generation to generation to generation.

WHY CONSIDER A DYNASTY TRUST?

According to its advocates, a dynasty trust can:

- Remove assets from the grantor's estate, and possibly from exposure to estate and generation-skipping transfer taxes.
- Provide financial security for trust beneficiaries by allowing them the use and enjoyment of trust property without the transfer tax problems.
- Protect trust assets from the claims of a spouse who divorces a beneficiary, and
- Insulate property from creditor's claims (including a divorcing spouse).

Additional reasons to create a dynasty trust include:

- Saving federal, state, and local income taxes.
- Saving federal, state, and local intangibles taxes.
- Providing long-term investment management (particularly for minor or physically, mentally, or emotionally disabled individuals).
- Protecting beneficiaries from well (or not so well) meaning "advisors."
- Protecting beneficiaries from inexperience or imprudence, providing incentives for certain behavior that reflects the grantor's values and work ethics (e.g. extra distribution to beneficiaries upon the completion of college, or graduate school, to start a business, upon marriage, or the birth of children).
- Keeping the control of family-owned assets (e.g. a family compound or the voting control of a family business entity)

WHO SHOULD CONSIDER A DYNASTY TRUST?

In my opinion, a dynasty trust should be considered only if:

1. The client/grantor's net investable wealth is significantly in excess of \$10,000,000. In order to achieve significant tax and non-tax benefits, the grantor must be willing to gift assets in excess of the GST exemption amount (currently \$2,000,000) to a long-term trust.
2. The client's wealth is growing significantly faster than his/her personal living expenses, personal gifts, and charitable gifts, and is very unlikely to ever need the assets gifted to the trust.
3. The client is seeking asset protection from malpractice suits or creditors (of him/her self and for children and lower generations),
4. The client is very unlikely to ever need the money or other assets in the trust,
5. The client has assets (e.g. real estate or a business interest or stock that may go public) highly likely to substantially appreciate.

WHO SHOULD NOT CREATE A DYNASTY TRUST?

A person who does not meet the criteria above should not consider creating a dynasty trust. Because of the complex (some would say arcane) principles of tax, property, and fiduciary law involved, and the fact that the trust must be drafted to take into consideration changing tax laws, financial conditions, as well as personal situations, the client must be willing to pay for extremely competent and highly experienced legal advice; otherwise a dynasty trust would not be a suitable planning tool.

Similarly, dynasty trusts would not be beneficial to those who do not want to tie up family wealth for perpetuity, who are not concerned with or want to "control from the grave," or who are not able or willing to give up large amounts of wealth.

HOW A DYNASTY TRUST IS CREATED

Creating a dynasty trust entails placing a very large amount of assets into a specially designed irrevocable trust. In most cases funding such a trust will (and should) exhaust the client's current unified credit exclusion amount and generation-skipping transfer tax (GSTT) exemption. (In some cases the payment of gift tax may be required.)

A client who has not used any of his/her gift tax exemption can transfer as much as \$1,000,000 (\$2,000,000 in the case of a married couple) into a dynasty trust with no federal gift tax liability.

THE "MONEY PUMP" CONCEPT

By establishing a dynasty trust that is leveraged with life insurance, the client is essentially creating what some planners call a "money pump." The trustee then revs up that "engine" created with the large initial infusion of capital by investing that capital in ways calculated to produce the largest possible return over long periods of time. That can be investments in long-term growth stocks, but is typically an "investment" in insurance on the life of the client, that of the client's spouse, or a survivorship contract on both lives; and in some cases, the client's adult children's lives.

The insurance can be whole life, variable life, universal life, variable universal life, or some other form or combination of permanent coverage. Quite often, this insurance is at least partially of the second-to-die (survivorship) type.

A TRUST FOR THE LONG (LONG) RUN

There is no provision under federal law that limits how long a dynasty trust can last. Under the terms of the dynasty trust, the trust will continue to exist for the longest period of time permissible under the law of the state where the trust is to be formed. In past years, the time a trust could continue was limited by what was known as the "rule against perpetuities" (discussed

in more detail below). This rule limits how long property may be held in a trust before someone must be given absolute ownership rights. The purpose of the law against perpetuities was to avoid great amounts of wealth (and the consequent power and economic control) accumulating in a few families' hands.

Because the purpose of the dynasty trust is to withhold such ownership as long as is legally possible, these trusts are typically set up in a state which has modified (i.e., lengthened) or – as many states have in the last decade – abolished the rule against perpetuities.

SAVING TAXES

The tax objective of a dynasty trust is to avoid the imposition of state and federal transfer taxes on a continually growing "family bank" of wealth, while affording beneficiaries a form of enjoyment of these assets that approaches (and in some respects and perspectives is better than) outright ownership.

Dynasty trust documents specify that the trust should be managed for its beneficiaries in such a way that federal estate and generation-skipping transfer taxes are avoided or minimized for as long as possible, while achieving the grantor's and beneficiaries' personal needs and objectives and satisfying their goals for as many generations as possible.

BENEFICIARIES GET USE BUT NOT OWNERSHIP

To achieve the two key objectives of a dynasty trust, as I mentioned above, the trustee will make trust assets available without making actual distributions of principal.

EXAMPLE

Your client's dynasty trust might purchase a family compound on the lovely shores of Lankford Creek on the Chesapeake Bay for his children and grandchildren's use. In fact, many generations could use that family compound – but they would not own and could not sell it, give it away, or encumber it. The property would remain a trust asset, rather than become the property of any one or more specific beneficiaries.

This is all accomplished in much the same way one might allow one's children to use his or her cabin in the mountains for a month at no charge. Let's suppose a trust beneficiary wants to purchase a home. Rather than distribute the money to a child or grandchild to purchase a home that he or she and his or her spouse would own (and eventually be taxed in their estates), the trustee would purchase that home for the trust. The dynasty trust would consider the purchase as a trust investment and would make it available for the use and enjoyment of trust beneficiaries.

It is even possible for the trustee of a dynasty trust to make tax-free medical and tuition payments directly to the service provider and institution on behalf of trust beneficiaries.

HOW CAN FLEXIBILITY BE PROVIDED?

Since a dynasty trust is intended to last for generations, building flexibility into the trust provisions is important to meet changing needs and circumstances of future beneficiaries.

Here are some provisions to be considered:

- Although the dynasty trust will generally not make distributions of capital, distributions are permissible, and provision should be made to give the trustee the sole discretion to make them. In other words, the trustee may be given the sole discretion to distribute not only income – but capital as well.
- Broad distribution powers in the hands of the trustee to amend the trust or to add or delete beneficiaries, while not common, are possible.
- Most dynasty trusts also authorize the trustee to make loans to enable a trust beneficiary to purchase a home, start a business, or obtain estate liquidity.
- Beneficiaries can be given power to remove trustees and appoint successor trustees upon a vacancy.
- Of course, the classic special (limited) powers of appointment and naming one or more beneficiaries as trustee also enhance the dynasty trust's appeal.
- Finally, many dynasty trusts contain a provision that allows distributions of principal in order for trust beneficiaries to purchase sufficient life insurance to begin yet another round of dynasty trusts.

These all add to the flexibility of the trust in the event of:

- Tax law changes,
- Planning strategy change,
- Change in financial circumstances of the beneficiaries,
- Change in the lifestyle of beneficiaries, and
- Emergency or opportunity of beneficiaries.

WHAT IS THE "RULE AGAINST PERPETUITIES"?

The "rule against perpetuities" is a rule of law that limits the duration of trusts. In its original form, as created by the courts of England, the rule was that all interests in a trust must vest (be owned or controlled with the beneficiary's absolute right to sell or otherwise dispose of the property) within twenty-one years after the deaths of the "lives in being" when the trust was created.

Another purpose of this rule was to limit the "dead hand rule" of trusts, i.e., to make sure that property could be sold and managed in accordance with the wishes of the living, and not according to the dictates of those long dead.

The net effect of the rule was to allow a person to create trusts which could last for the lifetimes of children ("lives in being at the trust creator's death") and until the creator's grandchildren were adults (which would occur no later than twenty-one years after the deaths of all of the grantor's children).

In 1990, the National Conferences of Commissioners for Uniform State Laws (NCCUSL) proposed the Uniform Statutory Rule Against Perpetuities Act (USRAP), which has been enacted in 27 states.

The USRAP modifies the original common law rule to allow the court to "wait and see" whether or not a trust actually violates the rule before invalidating the trust, and gives the trust at least 90 years in which to see whether the trust violates the rule. (Under the original common law rule, a trust was invalid from the beginning if some series of events could be imagined under which the rule would be violated, regardless of how unlikely those events might be. A classic example is a trust that is invalid because of the theoretical possibility that an 80-year-old widow might have a baby.)

The Uniform Trust Act proposed more recently by the NCCUSL takes no position on the rule against perpetuities, but in the last decade there has been a spate of state legislatures repealing or modifying the rule to allow trusts to last for much longer periods of time, or perhaps forever.

Many states (e.g. South Dakota, New Jersey, Rhode Island, and Idaho) have simply abolished the rule entirely, allowing newly created trusts to last forever. In Delaware, a trust of personal property (i.e., stocks and bonds and other investments other than real estate) may last forever, and trusts of real estate are limited to 110 years, regardless of the lives in being at the time the trust was created or the ages of the beneficiaries. Alaska still has a rule against perpetuities, but does not apply the rule to the "domestic asset protection trusts" (DAPT) in which the creator of the trust gives the trustee the discretion to make distributions of income or principal to the creator of the trust. Wisconsin has a rule against restrictions on alienation, but allows trusts to last forever as long as the trustee has the power to sell any of the assets.

STATE LAWS AND DYNASTY TRUSTS

As I've just pointed out, a number of states have enacted laws which make them considerably more hospitable to dynasty trusts and generation-skipping trusts. These new laws allow trusts to last longer, reduce the taxes on the trusts, or make it easier to administer the trusts.

As I explained above, the "rule against perpetuities" in most states limits generation-skipping trusts to children and grandchildren, which is about 90 years in most cases. However, a number of states (e.g., Alaska, Delaware, Idaho, New Jersey, Rhode Island, and South Dakota) have limited or abolished the rule against perpetuities, so that trusts created in those states can last longer than trusts in other states, or perhaps last forever.

Some states also have no state taxes on trusts with capital gains, or which accumulate income for future generations. Alaska has no income tax at all. Delaware has no income tax on capital gains or income accumulated for nonresident beneficiaries.

Although some states will attempt to tax trusts based on the residence of the grantor of the trust, not the residence of the trustee, there may still be advantages in locating a trust in a state with favorable tax rules.

Keep that point in mind; as noted below, even if your client lives in Florida, it may be possible to base your client's trust on Delaware or Alaska's or some other state's laws.

A state may also be considered to be favorable to dynasty trust administration because the laws of the state may:

- permit the trustee wide discretion in trust investments,
- permit the trustee to delegate investment decisions,
- provide liberal rules regarding trust accountings, or
- provide additional assurance of trust confidentiality.

Attorneys select the appropriate state by ascertaining which state is most likely to:

- honor the grantor's objectives,
- allow the trust to run the longest (preferably perpetually),
- result in the lowest possible state income or intangible personal property tax,
- maximize asset protection, and which has adopted what is known as the "prudent investor rule" which enables the trustee to acquire and retain almost any type of investment,
- maintain the highest possible level of confidentiality,
- offer a strong unitrust statute (permitting an income trust to be converted to a total return unitrust (TRU)).

In order to claim that a trust is a resident of a state that is different than the state in which your client lives and that the trust should be subject to the laws of that other state, it is necessary (at a minimum) that the trustee of the trust be a resident of the other state. It may also be necessary to manage the trust investments within the state, or have other contacts between the trust and the state which you'd like to use.

Attempting to choose which laws of which state will apply to a trust (called selection of situs), complying with the tax laws of different states, and resolving the possible conflicts between the laws of different states, are obviously tasks that must be left to a very experienced lawyer.

HOW IS ESTATE AND GENERATION SKIPPING TAX SAVED?

Upon placing assets in a dynasty trust, since the grantor no longer owns them, they should not be includable in his/her estate. This even applies to life insurance (assuming the grantor lives for more than three years after transferring it or it is owned from inception by the trust).

Although most authorities suggest fully utilizing the grantor's (and the grantor's spouse's) unified credit equivalents as quickly as possible, it is possible to fund a dynasty trust over a period of years.

The key to leveraging savings is to place enough cash in the trust to pay the premiums on life insurance, preferably a second-to-die life insurance policy (or policies). Contributing more than the premium amounts will maximize the use of the client's GSTT exemptions and assure adequate funding for the policy or policies. (Care must be taken to allocate the grantor's GSTT exemption to the gifts (i.e., premiums) to the trust.)

The most efficient use of a dynasty trust occurs when the trustee is not required to make income distributions to parents, siblings, children, nieces, or nephews (so called "non-skip persons). Even more wealth can be kept in the family (assuming those beneficiaries can afford it) if the trustee makes little or no discretionary distributions of principle or income.

By making the dynasty trust a "grantor" trust for federal income tax purposes (by retaining certain powers which will cause the client to be taxable on the income yet not resulting in estate tax inclusion), retained trust income should be taxable to the grantor rather than to the higher-bracket trust. Typically, this is accomplished by either giving the grantor the power, exercisable in a non-fiduciary capacity, to re-acquire trust assets by substituting property of an equivalent value or by giving an independent trustee the power to add charitable beneficiaries (or preferably using both powers).

If there has been no allocation of the GSTT exemption, GST tax will be payable at each generation. But if and when a GST tax is paid, the transferor will be moved down a generation so that distributions to the next income beneficiary will not be considered taxable distributions.

WHAT ARE THE BEST ASSETS TO FUND A DYNASTY TRUST?

By now it should be obvious that the highest possible leverage will come from the judicious use of life insurance coupled with income producing property. Other assets indicated are high basis assets that are likely to significantly appreciate, assets that the family wants to retain, and cash.

Among the assets that are contra-indicated are "income in respect of a decedent" (IRD), and certain bonds.

WHAT ARE THE DOWNSIDES OF A DYNASTY TRUST?

I want to specifically note that, although some of the most brilliant estate planning lawyers in the United States are establishing dynasty trusts for their ultra-wealthy clients, there are no specific Code sections, regulations, rulings, or court cases that specifically sanction or bless the concept of a dynasty trust or assure the package of benefits claimed for them. Specifically, the tax implications of allowing trust beneficiaries to use, but not possess, massive amounts of trust assets over multiple generations has not yet been thoroughly tested by the IRS and the courts.

So it is possible that there could be adverse tax consequences of that part of the dynasty trust concept. The IRS already imposes taxes on certain large intra-family loans, and Congress might impose income or gift taxes on (for example) the rent-free use of trust property. The IRS has also expressed concern about the creation of generation-skipping transfer trusts which extend past the period allowed by the traditional rule against perpetuities.

Congress did not expect that states' laws would change so drastically or that trusts would last more than the 90 to 100 years previously commonly allowed. It is therefore possible that at some point, Congress or the IRS may act to limit the generation-skipping tax benefits of dynasty trusts.

Since this concept should only be considered for the transfer of millions of dollars of wealth, I suggest that only the best and the brightest and most experienced tax professionals should be used when deciding if a dynasty trust is appropriate.

SUMMARY

Dynasty trusts should be considered only by the very wealthy and the super-wealthy.

Years ago, the number of individuals who fell into this category was quite limited. Today, almost one thousand people in the U.S. are billionaires – and many in our country have wealth greatly exceeding \$10,000,000.

Trusts are among the most important of all estate planning tools – and the dynasty trust – coupled with life insurance when possible – significantly leverages the advantages and many benefits of trusts

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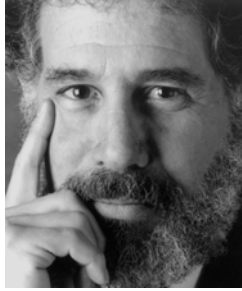
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