Fall 2016 Bulletin

Dynasty Trusts May Be Even More Powerful After Changes in Transfer Tax Law

The tax and creditor protection advantages of dynasty trusts will make these trusts more attractive as family wealth preservation tools in the event of repeal of the estate and GST taxes, or if the estate and GST tax exemption is increased.

Although there is no precise definition of the term "dynasty trust," the term is generally used to refer to any trust designed to continue for multiple generations. Dynasty trusts are often created in jurisdictions that have repealed the common law "rule against perpetuities" so that the trust can last forever. There are many states that either have completely repealed the rule against perpetuities altogether or have extended the permissible term of a trust for a long enough period that, as a practical matter, it is possible to create a "dynasty trust". The following states either have no rule against perpetuities or have a very long perpetuities period:

Permit perpetual trusts: Alaska, Arizona, Colorado, Delaware, District of Columbia, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, South Dakota, Virginia, and Wisconsin.

Permit very long trusts: Florida (360 years); Nevada (365 years); Utah (1,000 years); Washington (150 years); and Wyoming (1,000 years).

With the increase in the applicable credit amount to a dollar figure that is much larger than what is available today, practitioners are often faced with questions from friends and family (and even colleagues), such as: "What are you going to do for a living if they get rid of the estate tax?". Many people have the impression that without a substantial estate tax, the business of planning and administering trusts will decrease, because wealthy and upper middle-class clients will no longer need to create credit shelter trusts, GST tax-exempt trusts or other trust structures that are created principally for tax planning purposes.

Though it may appear that a repeal of the estate and GST taxes or a significant increase in the applicable credit amount would reduce the number of trusts being created; it seems more likely, however, that the effect of these changes in the federal transfer tax laws will be to help convince many families that a properly designed dynasty trust is a more powerful planning tool than ever before and that such a trust will place the family in the best possible strategic position to: (i) protect family assets from creditors; (ii) avoid or minimize state income taxes; (iii) increase family wealth; and (iv) react constructively to the inevitable, but as yet unpredictable, future developments in the tax laws. As a practical matter, prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the size of a dynasty trust was effectively capped at the maximum GST exemption amount. EGTRRA permits the creation of dynasty trusts by United States settlors that are much larger than before (currently $5.45 million for an individual and $10.9 million for a couple)

When the changes to the transfer tax laws that are predicted become a reality, a much larger or even unlimited amount of assets could be used to fund a dynasty trust without incurring adverse income, estate, or GST tax consequences. These trusts can be designed to take full advantage of the changes in the tax laws that one can reasonably anticipate in the

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years to come. Furthermore, a well-designed dynasty trust can be a powerful tool for making intergenerational transfers of wealth, while also protecting assets from creditors' claims.

Continuation of gift tax

In the future, if the gift tax in effect looks like it does under EGTRRA, the gift tax will be triggered by any transfer in trust (even if the transfer would otherwise have been treated as an incomplete gift) unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust rules. [3] This exception for transfers to a grantor trust will be a key aspect of the techniques used by wealth planners. Perhaps more important for the techniques described in this bulletin is the fact that distributions from a dynasty trust, including distributions pursuant to the exercise of a beneficiary's limited power of appointment, will not be treated as taxable gifts, regardless of the identity of the recipient of the distribution.

Dynasty trusts can help avoid gift tax and a future estate tax

It is generally agreed or, at the very least, an estate tax exemption of $3.5 million or more will be the law of the future. In such a case, the gift tax would remain in place and will undoubtedly be the tax planner's biggest challenge in intergenerational wealth planning. If the prognosticators are correct, the avoidance of gift taxes, without delaying intergenerational wealth transfers until death, will become the most difficult transfer tax problem.

A dynasty trust can be used to entirely avoid this type of gift tax problem, because distributions from the trust would not be taxable gifts and, therefore, distributions from the trust could be made as and when deemed appropriate by the family and the trust's fiduciaries without regard to gift tax considerations. For example, consider a wealthy client whose entire estate could fund a flexible dynasty trust that could sprinkle distributions among generations of the client's descendants, while providing creditor protection and allow the beneficiaries to enjoy substantial control over the trust. The beneficiaries could be given lifetime limited powers of appointment and/or testamentary limited powers of appointment and could make “gifts” from the trust, as and when they desire that are not subject to the gift tax regime remaining in place.

In other words, the settlor's descendants can enjoy the benefit of the trust assets for many generations in the future, and because the exercise of a limited power of appointment over trust assets is not treated as a gift, the dynasty trust's beneficiaries can make intergenerational wealth transfers, as and when appropriate, without incurring gift tax through the exercise of limited powers of appointment. If the beneficial interests include fixed rights to receive distributions, such as an income interest, the exercise of a lifetime limited power of appointment could present adverse gift tax consequences.

Imagine that a wealthy client simply gives all his assets outright to his grandchildren to the extent of the GST tax exemption. Now those assets are in the grandchildren's hands. Those assets would be included in the grandchildren's estates.

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If any of the settlor's other descendants (like a grandchild's issue, for example) ever need the money, the grandchild would be limited by the then lifetime gift tax exemption in making that gift. If those assets were in a dynasty trust, the grandchild would be able to make that same transfer, free of gift tax, through the exercise of a limited power of appointment in favor of the appropriate donee.

Why a dynasty trust should be attractive to descendants

Control, creditor protection, state income tax avoidance, and flexibility. At times, descendants have the misconception that trusts are designed to take away rights from them as beneficiaries, control the money from the grave, or worse yet, enrich the lawyers and trust companies to the detriment of the family. From the point of view of the settlor's children and more remote descendants; however, the receipt of their inheritance in the form of a properly designed dynasty trust rather than as an outright bequest will benefit them in many ways and not harm them. The challenge for a wealth planner is to make the descendants understand and appreciate that a bequest in trust can provide them with all the use and enjoyment of the assets that an outright bequest would provide, with a few key additional benefits.

A dynasty trust can be designed to permit each child (and more remote descendants) to enjoy sufficient rights in his or her share of the trust so that the child's share is, as a practical matter, tantamount to outright ownership. The child can, for example, control investments, have the power to remove and replace trustees, direct distributions from the trust (but not directly to the child or in discharge of a support obligation), and even act as a co-trustee—all without adverse tax consequences or exposing the assets to creditor claims. These objectives can be achieved through roles defined in the trust agreement such as an Investment Advisor, Trust Protector, Distribution Advisor, and Removal and Appointment Committee. Detailed language can provide beneficiaries with the right to remove and appoint those advisors (and the trustee) or to serve as an advisor (or trustee) themselves. In addition, some or all of the beneficiaries can have lifetime and/or testamentary limited powers of appointment. All of these rights and powers can be enjoyed by successive generations, while the assets continue to reside in a transfer tax safe-haven that is exempt from ever incurring any estate, GST, or gift tax.

A settlor who would have otherwise given the assets to his or her children free from trust would generally be much better off putting those assets in a properly designed dynasty trust which provides the children and more remote descendants with the broadest rights and interests imaginable, without causing estate inclusion and without causing any transfer of the assets from the trust to be treated as a taxable gift. In addition to the significant transfer tax benefits of the dynasty trust and the flexibility a dynasty trust can provide, another attractive incentive for creating a dynasty trust is the fact that the grandchild's creditors won't have the opportunity to wipe out the trust for future generations, if the trust instrument includes a spendthrift provision. A properly

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designed trust agreement can protect the family wealth from spouses (or ex-spouses) and creditors. Furthermore, in many cases it may be possible to avoid all state income taxes on income and capital gains accumulated in the trust, even if the beneficiaries live in high income tax states.

With proper drafting, a dynasty trust agreement can be designed to provide beneficiaries with substantial benefits, in addition to the traditional right to receive an outright distribution, that will protect the assets from creditors and transfer taxes, by retaining the assets in the trust for the use and benefit of the beneficiaries. For example, a trust agreement could allow the trustee to: (i) purchase residential real estate and allow a beneficiary to live in the residence rent-free; (ii) allow beneficiaries to use any property owned by the trust; (iii) guarantee loans of the beneficiaries; (iv) invest in business ventures owned or managed by a beneficiary; or (v) make loans to the beneficiary to start up a business (or make loans to the company).

Instead of making a large distribution to a beneficiary to purchase a home, if the trustee purchased the home within the trust and allowed the beneficiary to live in it, the value of that home would continue to take advantage of all of the transfer tax and creditor benefits described in this Bulletin and would be preserved for future generations without taking away from the use and enjoyment of the house by the beneficiary living there. In addition, the trust agreement could contain provisions which create a supplemental needs trust for a beneficiary, if it is possible to maximize that beneficiary's eligibility for governmental benefits while having supplemental needs met through the trust's assets.

A dynasty trust can also be drafted to provide the trustee with certain guidelines concerning distributions. For example, the settlor could express an intent that distributions not be made to or for the benefit of beneficiaries to be used for any illegal purposes, or for drugs, alcohol, or gambling. The dispositive provisions could state that distributions should not be made for the expenses and costs of basic support and maintenance of a healthy, competent beneficiary who is of working age and is not a full-time student, in order to encourage a healthy, competent beneficiary to put forth reasonable effort to pursue a career and earn income from work.

The settlor could express an intent that distributions be made for the benefit of a beneficiary who does not have adequate assets to acquire health insurance, disability or long-term care insurance coverage. The trust could encourage beneficiaries to develop productive business skills by making loans to a beneficiary for a business enterprise in which a beneficiary is involved, if the beneficiary possesses good judgment and financial acumen and the beneficiary presents the trustee with a professional business plan.

A dynasty trust can be drafted with as much flexibility as the settlor desires. A trust protector or the trustee can be given the power to amend the trust agreement as may be advisable for reasons as to: (i) preserve favorable tax treatment; (ii) address changes in the law; or (iii) address changing economic conditions or family

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circumstances among the beneficiaries. A dynasty trust may be drafted to permit the trustee to "decant" trust assets to new trusts designed to meet changing needs or circumstances. Some states provide trustees with a so-called decanting power to make distributions to a new trust for one or more beneficiaries of the original trust that has administrative terms that are different from those of the original trust. [5]

Lifetime and testamentary transfers

For many years, one of the fundamental principles of the wealth transfer tax system was that it was less expensive and more tax-efficient to give assets away during lifetime than it was to hold the assets until death, because the effective rate of tax on lifetime gifts was substantially lower than the effective rate of the estate tax. It is still true that lifetime gifting up to the amount of the gift tax exemption can minimize transfer taxes. Therefore, dynasty trusts created under EGTRRA and after repeal of the estate tax or expansion of the estate tax credit should be either testamentary or, if created during lifetime, should be designed as incomplete gifts, except to the extent of the donor's available gift tax exemption.

Inter vivos dynasty trusts (designed so that contributions to the trust are completed gifts during the grantor's lifetime) are often structured as grantor trusts for federal income tax purposes, thereby increasing the value of the gift to the trust. Rev. Rul. 2004-64 [6] made it clear that a grantor's payment of income tax on the income of a grantor trust, the contributions to which were completed gifts, will not be treated as a gift to the beneficiaries.

If such a trust is designed to potentially accumulate trust income or principal during a settlor's lifetime, and the trust is structured as a grantor trust, the value of the gift to the trust will be enhanced, because the trust assets do not need to be consumed to pay the income tax applicable to the trust's income. The payment of income tax by the grantor effectively allows the grantor to make an additional "gift" to the trust beneficiaries in the amount of the income tax paid without having to pay any gift tax.

Conclusion

The tax and creditor protection advantages of dynasty trusts make use of dynasty trusts extremely attractive as family wealth preservation tools.

Without the effective cap on the size of a dynasty trust imposed by the GST tax, dynasty trusts funded at higher levels will be a much better way to pass assets to future generations than are outright bequests. Over multiple generations: (i) the tax savings (including state income tax savings); (ii) creditor protection; (iii) consolidated asset management; (iv) and the appreciation in value of all that preserved wealth provide an exponentially greater economic benefit to future generations.

PRACTICE NOTES

A dynasty trust can be designed to permit each child (and more remote issue) to enjoy sufficient rights in his or her share of the trust so that the child's share is, as a practical matter, tantamount to an outright gift.

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