

# DYNASTY TRUSTS

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Understanding Dynasty Trusts

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### DYNASTY TRUST

A Dynasty Trust is an irrevocable trust designed to allow its creator to pass wealth from generation to generation without the burden of transfer taxes, including estate tax and generation-skipping transfer (GST) tax.

### BRIEF DESCRIPTION OF A DYNASTY TRUST

- A Dynasty Trust is designed to maximize a person's gift and GST tax exemptions for as many generations as applicable state law permits<sup>1</sup>.
- A Dynasty Trust may be drafted so that the assets of the trust should not be subject to creditor or divorce claims against a beneficiary.
- A Dynasty Trust is designed to receive gifts<sup>2</sup> from the grantor or to borrow funds from the grantor to make investments on behalf of the beneficiaries. The Trustee will use the trust assets for the benefit of the beneficiaries during their lifetimes.
- A Dynasty Trust could contain special provisions that qualify it as a "grantor trust" for income tax purposes without causing its assets to be included in the grantor's taxable estate at death.
- As a result, although assets transferred to a Dynasty Trust, and all appreciation of those assets, will be removed from the grantor's estate for estate tax purposes, the grantor will still be taxed on the income generated by the Dynasty Trust's assets.

### POTENTIAL BENEFITS OF A DYNASTY TRUST

- **A Dynasty Trust Could Allow Successive Generations of Descendants to Access Wealth Without Transfer Taxes.**
  - › **NOTE:** The grantor should consider creating the trust under the laws of a state which has no limit on the

length of time assets may remain in trust.

- › **NOTE:** Sufficient GST tax exemption must be allocated to the trust to ensure the assets are not subject to the GST tax.
- **Assets of the Dynasty Trust Appreciate Outside of the Taxable Estate.**
  - › **NOTE:** Appreciating assets are attractive candidates to be gifted to a Dynasty Trust. The assets transferred and all appreciation of those assets should pass free of transfer taxes.
  - › In addition, the Trustee can use the Dynasty Trust and cash generated by the assets transferred to it (or funds lent to the Dynasty Trust by the grantor in the future) to make investments in new ventures for descendants or to purchase life insurance on the life of the grantor.
- **Income Tax Payments Should Not Constitute Gifts.** As the "grantor" of the Dynasty Trust for income tax purposes, the grantor will pay the income taxes related to the income generated by the assets of the Dynasty Trust. The income tax payments:
  - › Should not constitute gifts by the grantor for gift tax purposes; and
  - › Should reduce the amount of wealth subject to estate taxes when the grantor dies.
- **Grantor Trust Status May Be "Turned Off."** A "Special Trustee" may be given the power to amend the Dynasty Trust so that the grantor is no longer taxed on the income from the assets of the Dynasty Trust.
  - › **NOTE:** The Special Trustee provisions also provide flexibility to accommodate certain changes in the tax laws and family circumstances.
- **Risks of Using a Dynasty Trust:**
  - › A Dynasty Trust is an irrevocable trust the terms of which may not be amended by the grantor.
  - › Gifts to a Dynasty Trust cannot be reacquired.

<sup>1</sup> Under the laws of many states, the duration of trusts is limited so that the assets of the trust must be distributed from the trust within a period measured by a life or lives in being (alive at the creation of the trust) plus 21 years (typically 90 years). However, many states have enacted laws that eliminate or modify this rule and permit trusts that continue for very long periods, including trusts that may continue forever.

<sup>2</sup> For GST tax purposes, the grantor must apply his or her GST tax exemption to 100% of the gifts (both lifetime and annual exclusion).

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## FUNDING A DYNASTY TRUST

Generally, there are three ways to move assets into a Dynasty Trust: (i) Gift; (ii) Loan and/or (iii) Sale.

- **Gifts to a Dynasty Trust.** A grantor may make a gift to a Dynasty Trust in an amount up to the grantor's remaining lifetime gift tax exemption without paying any gift tax.<sup>3</sup>
  - › In 2013, a grantor could gift up to \$5,250,000<sup>4</sup> to a Dynasty Trust without paying any gift tax.
  - › Alternatively, a grantor could also make annual gifts to the trust using his or her annual gift tax exclusion (currently \$14,000 per beneficiary of the Dynasty Trust).
- **Loans to a Dynasty Trust.** A grantor may make loans to a Dynasty Trust.
  - › Such loans could be used to fund life insurance premiums or could allow the trust to make investments in new ventures.
  - › The IRS requires interest to be paid on these loans. For example, the June mid-term Applicable Federal Rate is 0.95% for a 9 year loan.
- **Sale to a Dynasty Trust.** A grantor may sell assets to a Dynasty Trust in exchange for a promissory note.
  - › Appreciation on the assets sold to the trust in excess of the interest rate payable on the note should escape transfer taxes.
  - › The promissory note could be structured so as to provide flexibility to accommodate the actual financial performance of the assets transferred to the trust.
  - › No capital gains should be due on the sale because the transaction is disregarded for income tax purposes.

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## PLANNING CONSIDERATIONS

- Creating a Dynasty Trust and transferring assets to it involves complex financial, legal, tax, and other considerations. Please consult with tax and legal counsel before proceeding.
- In addition, a Dynasty Trust is an irrevocable trust and therefore cannot be changed or revoked by the grantor after it is created.

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<sup>3</sup>The grantor should ensure he or she allocates sufficient GST to cover 100% of the gift(s).

<sup>4</sup>Less any taxable gifts made during life.

<sup>5</sup>This ignores the inflationary adjustment to the estate tax exemption.

<sup>6</sup>For the purposes of this example we have the assets of Husband and Wife have not appreciated.

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## EXAMPLE - USING LIFE INSURANCE TO LEVERAGE A GRANTOR'S GST TAX EXEMPTION

For purposes of this example, we have made the following assumptions:

- Husband and Wife and each 50 years old and have a net worth of approximately \$20,000,000 and have one Child.
- Husband and Wife each have a \$5,250,000 gift tax exemption and \$5,250,000 GST exemption.
- Existing estate plan distributes assets outright to Child at the death of the surviving spouse.
- The estate tax is 40%.

**Do nothing, at the death of the surviving spouse the estate passes as follows:**

- **\$3,800,000** [ $20,000,000 - 10,500,000 = 9,500,000 * 40\% = 3,800,000$ ] to the IRS; and
- **\$16,200,000** [ $20,000,000 - 9,800,000 = 16,200,000$ ] to Child.
- Child lives 30 more years with assets growing at 4%.
- At Child's death:
  - › **\$18,917,215** [ $52,543,040 - 5,250,000^5 = 47,293,040 * 40\% = 18,917,215$ ] of estate tax is due, leaving **\$33,625,825** [ $52,543,040 - 18,917,215 = 33,625,825$ ] to grandchildren.
- Total estate taxes paid: **\$22,717,215** [ $3,800,000 + 18,917,215 = 22,717,215$ ]

**Create a Dynasty Trust; Fund it with lifetime gift tax exemption; Buy second-to-die life insurance**

- Husband and Wife create a Dynasty Trust and make a \$10,500,000 gift to the trust. GST exemption is allocated to 100% of the gift.
- The Trustee of the Dynasty Trust purchases \$5,000,000 of second-to-die life insurance with annual premiums of \$27,000 and Husband and Wife live an additional 15 years.
- At the death of the surviving spouse<sup>6</sup>, the estate passes as follows:

- › **\$3,800,000** [ $9,500,000 * 40\% = 3,800,000$ ] to the IRS;
  - › **\$5,700,000** [ $9,500,000 - 3,800,000 = 5,700,000$ ] to a non-GST trust for Child; and
  - › **\$15,500,000** [ $10,500,000 - 405,000 + 5,000,000 = 15,095,000$ ] in Dynasty Trust for Child.
- Child lives 30 more years with assets growing at 4%.
  - At Child's death:
    - › Assets in the non-GST trust have grown to **\$18,487,366**.
    - › Child has a \$5,250,000 exemption.
    - › The non-GST trust triggers estate tax of **\$5,294,946**, leaving **\$13,192,419** to grandchildren for the non-GST trust
- › **However, \$48,959,085 passes to grandchildren free from estate tax or GST tax in the Dynasty Trust.**
  - › This planning resulted in estate taxes savings of **\$13,622,270** and **\$28,525,681** additional assets being transferred to grandchildren.

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