SLG Schwartz Law Group, Inc.

Dynasty Trusts

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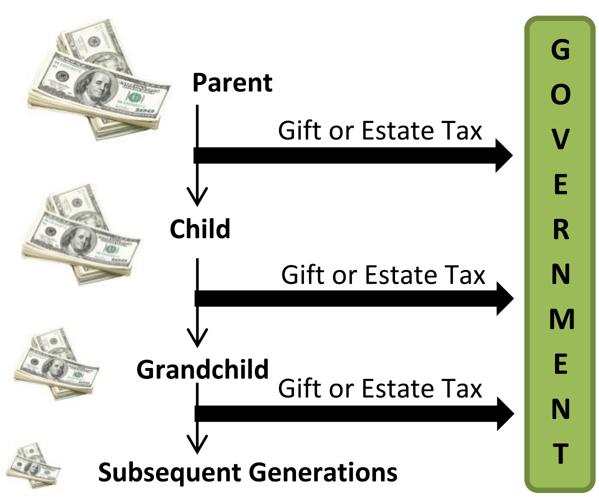
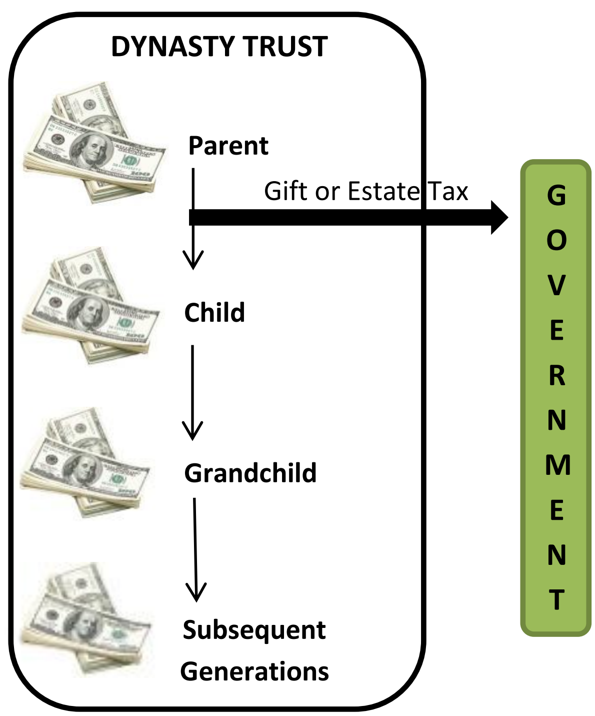
Rockefeller, Ford and Carnegie were three of the most prominent titans of American industrialization in the early 1900's. The great wealth each amassed from their respective industrial empires would be subject to significant taxes upon transfer. The significantly tax-reduced portion their children received would be further tax-reduced when their children transferred the wealth and so on for generations.



So, their attorneys created the Dynasty Trust. The idea was that the Trust itself owns the assets and since the Trust, unlike humans, is immortal… it should never have to pay death taxes! Parent would set up a Dynasty Trust for which Child would be a lifetime beneficiary. When Child died the Dynasty Trust assets would not be included in their estate and subject to death taxes because the Trust owns the property and is still alive. Grandchild would then be a lifetime beneficiary of the Dynasty Trust with the Trust assets not being included in their estate and so on for generations to come.



And with that, the basic structure of the Dynasty Trust came into being. Congress recognized the vast amounts of money that were being moved generation to generation free from transfer taxes and sought to limit these transactions. To do so, Congress imposed a Generation Skipping Transfer Tax (GSTT) in 1986 which added a tax on transfers two generations away or to significantly younger nonrelatives. The idea was that this new GSTT would apply to the transfers that avoided estate tax in Dynasty Trusts and collect the tax that was previously avoided.

However, just as Congress gave each individual a gift and estate tax exclusion amount (i.e., currently 5.34 million) which may pass free of gift and estate taxes, so too did Congress give each individual an equal exemption amount for GSTT.

Transfer Tax Rates and Exemptions for 2014

Fed. Estate Tax	Fed. Gift Tax	GSTT
40% $5.34 million exemption	40% $5.34 million exemption	40% $5.34 million exemption

The Dynasty Trust of the early 1900's has continued to evolve with the increased complexity of the Tax Code and needs of clients. The Dynasty Trust though remains an astoundingly powerful tool for long-term family wealth in the right situations and with proper planning and execution. Let's take a look at the broader considerations for planning with Dynasty Trusts.

WHEN TO USE A DYNASTY TRUST

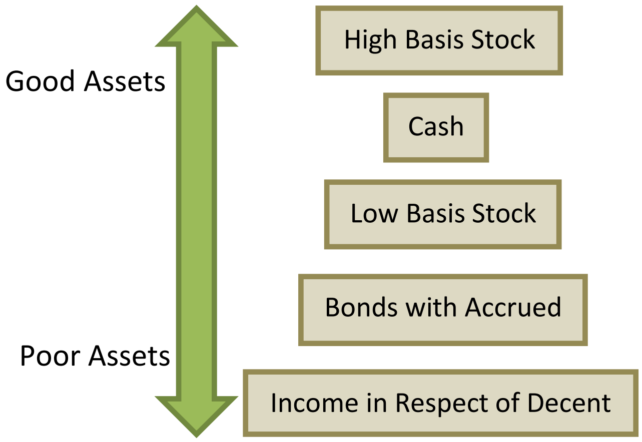
A Dynasty Trust is irrevocable. That is, once you execute the instrument specifying the terms of the Trust and transfer assets to it, you cannot change your mind later and revoke or modify the Trust. So, you should take time to consider all the possible consequences that may result before committing assets permanently to a Dynasty Trust. This also means that you need to have sufficient assets for your own comfort and support beyond those that you transfer to the Dynasty Trust.

SELECTING THE RIGHT ASSETS

The best assets to transfer to a Dynasty Trust are those in which you have a high basis that the Dynasty Trust can retain. Obviously, assets that will appreciate tremendously are preferred because they will provide the continued stream of cash flow to support multiple future generations. Cash is another asset that can be used but it will need to be wisely invested once transferred to the Dynasty Trust to make it productive.

Low basis stocks are not good assets to transfer to a Dynasty Trust because they will retain their low basis after the transfer and forego the opportunity to receive a stepped-up basis at your death. In contrast however, low basis real estate may be a preferable asset. Probably the worst assets to transfer to a Dynasty Trust are those that qualify as Income in Respect of Decedent. Another poor asset choice are bonds having accrued interest if the Trust treats the interest as received after the Trust was funded and requires income to be distributed currently.

The income tax that the Dynasty Trust and its beneficiaries must pay is another area to consider when selecting assets. If you fund the Dynasty Trust with tax-free municipal bonds, non-dividend growth stocks or cash-rich life insurance policies, the Trust will pay little or no federal income tax.

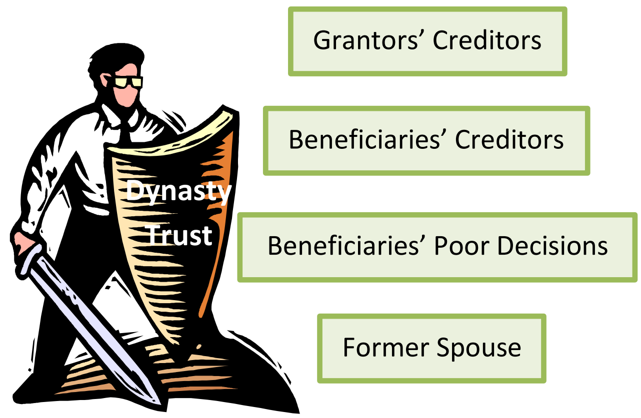


Again, a Dynasty Trust is only a good option when you can meet your current and future needs without the assets that will be placed in the Dynasty Trust. So, if you are creating a Dynasty Trust, only use excess assets that you do not need to live comfortably for the remainder of your life.

PROTECTION FROM CREDITORS

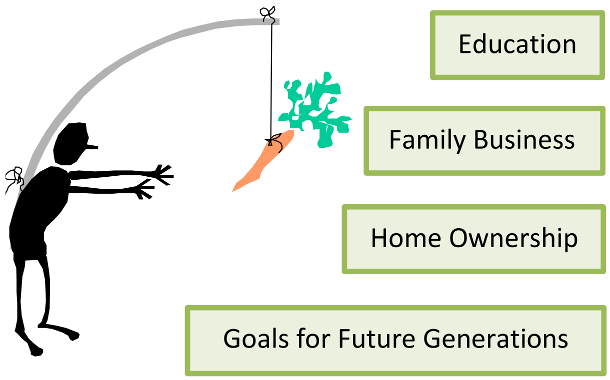
Dynasty Trusts can be important creditor protection tools in a variety of situations. Dynasty Trusts can provide protection from both the grantors' creditors as well as the beneficiaries' creditors. These protections can extend to divorce proceedings involving a beneficiary. Even beyond creditor protection, a Dynasty Trust is a useful vehicle to manage assets for a minor child or an adult that becomes disabled due to illness or old age.

So, how does the Dynasty Trust provide this creditor protection and management function? Well, remember that the beneficiaries do not own the assets held in the Dynasty Trust. This is helpful not only for tax purposes where it excludes the Dynasty Trust assets from being included in their estates but also when creditors or beneficiaries try to reach those assets. Often a creditor cannot reach the assets still held in the Dynasty Trust because the beneficiary-debtor does not actually own those assets. Therefore, the creditor likely can only reach those assets that are actually distributed to the beneficiary.



You will commonly see a Spendthrift Provision in a Dynasty Trust. This provision makes it clear that the beneficiary has only a beneficial interest in the trust assets and not an ownership interest. The provision also causes a beneficiary to automatically forfeit their interest in the event they attempt to encumber or alienate their interest in the trust assets or any attempted levy or seizure as to those trust assets by a creditor.

Yet another related non-tax advantage of a Dynasty Trust is to use the assets as a means to incentivize certain positive behaviors by the beneficiaries. The terms of the Dynasty Trust can call for distributions to children and grandchildren beneficiaries only if they complete certain educational milestones, to pay for certain types of life expenses like a down payment on a personal residence, or meeting other goals you have for future generations of your family.



CHOOSING A TRUSTEE

When choosing a Trustee, it is important to remember that the Dynasty Trust lasts in perpetuity. The best choice for Trustee today may end up being the worst choice for Trustee later. People suffer medical and mental illnesses sometimes when such ailments are completely unexpected. Therefore it is important to build some flexibility into the trusteeship.

You may want to consider appointing a corporate Trustee as co-Trustee with a friend or family member. This may ensure long-term stability and limit the unpredictability inherent in appointing a child, friend or other relative as sole Trustee who may later change immensely. You should also be sure to create an adequate successor trusteeship. A Dynasty Trust may last for several generations, so create a scheme for it that will determine who the Trustee will be several generations from now when all those family members currently alive has passed away. Again, the key is building in flexibility. Your unborn grandchildren may not be as responsible as you hope and the last thing you want is for them to be automatically and semi-permanently in a position to manage the Dynasty Trust assets.

It is also important to give clear instructions as to the purpose of the Dynasty Trust and the powers the Trustee has in managing the Dynasty Trust assets. These provisions must be exceptionally clear because they will guide the Trustee's behavior decades after you have passed away, when the Trustee will likely never have known you or your goals. The purpose of a Dynasty Trust typically is different than a standard Trust in that a Dynasty Trust is meant to provide prolonged support. Therefore, you should include provisions that instruct the Trustee to maintain Trust assets when possible. For example, you may instruct the Trustee to make loans to beneficiaries instead of distributions to them when possible.

TIME LIMITATIONS

There is a very complicated legal doctrine called the rule against perpetuities. For purposes of this article it will suffice to simply say that this doctrine serves as a limit on how long a Trust may last before it must distribute its assets and dissolve.

Each state has a different rule against perpetuities that will apply to all trusts governed by that state's laws. Thus, choosing which state to create the Trust in is an important decision. Some states do not have a rule against perpetuities, meaning the Dynasty Trust could potentially continue indefinitely with perpetual asset growth and support for generations decades or centuries from now.

Other states have such a long perpetuity period that it is essentially the same as allowing the Dynasty Trust to continue indefinitely. However, do note that President Obama has made repeated efforts to cap the perpetuities period in all states at 90 years, which is the perpetuities period in California anyway.

Perpetuities Period by State

No Rule Against Perpetuities
Alaska, Delaware, Maryland, Pennsylvania, Rhode Island, South Dakota, Idaho, Wisconsin
1,000 Years Rule Against Perpetuities
Colorado, Utah, Wyoming
360 Years Rule Against Perpetuities
Florida
90 Years Rule Against Perpetuities
California, Hawaii

It is important to note that the person creating the Dynasty Trust does not need to be a resident of a state in order to create a Dynasty Trust governed by the laws of that state. Instead, the Dynasty Trust simply must have some connection with the state. Even selecting a Trustee in that state may be enough connection to have that state's laws govern the Dynasty Trust. Delaware and Nevada for example merely require that the Trustee have a presence within the state but not the creator of the Dynasty Trust or beneficiaries.

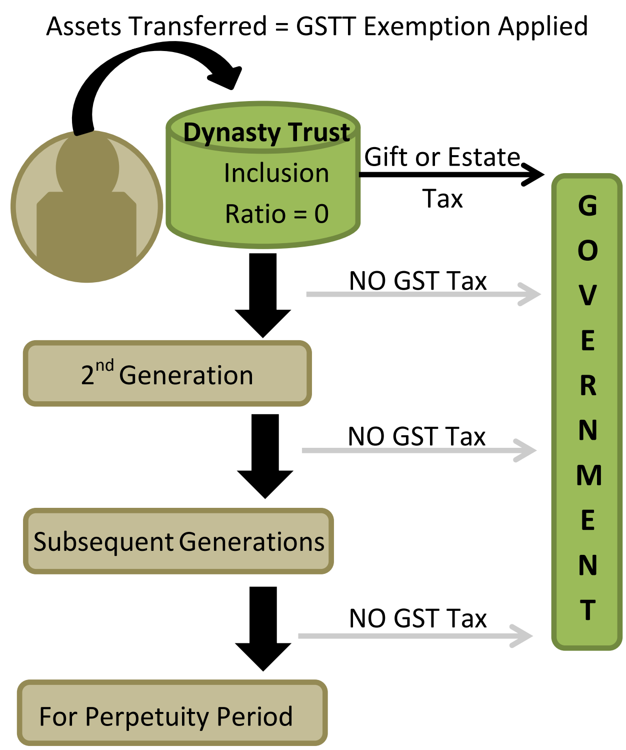
BUILDING IN FLEXIBILITY

As previously mentioned throughout it is important to create flexibility in the Dynasty Trust provisions. Everything changes with time—people, the economy, health, goals, and family dynamics to name just a few. The Dynasty Trust needs to address this reality and be able to adapt accordingly.

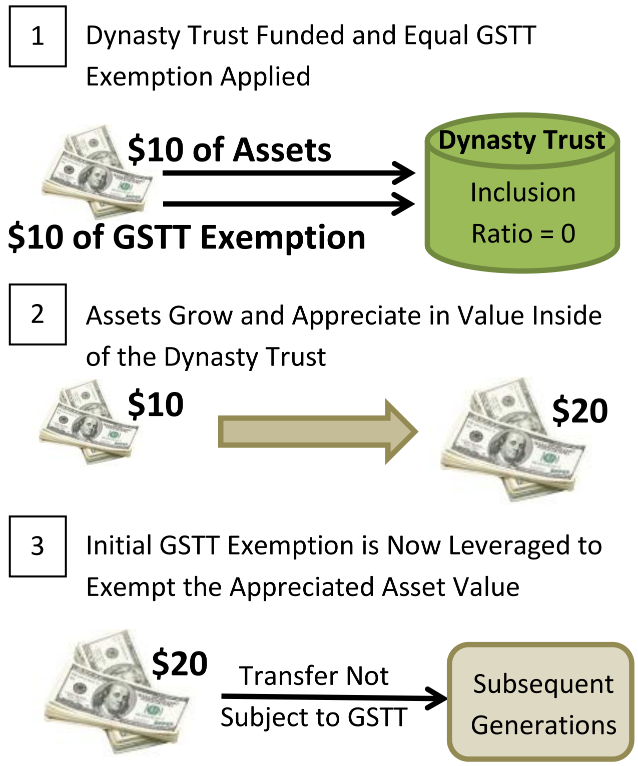
For instance, it may be a good idea to give the primary beneficiaries (i.e., the first generation) a limited power of appointment. This will essentially create a class of individuals from which the primary beneficiaries can designate who will be secondary beneficiaries.

LEVERAGING GENERATION-SKIPPING TRANSFER TAX EXEMPTION

As previously mentioned, each individual is given a $5.34 million GSTT exemption. This exemption amount should be applied to the initial gift to the Dynasty Trust and all subsequent gifts. When the amount of GSTT exclusion applied equals the amount transferred to the Dynasty Trust the Dynasty Trust has an inclusion ratio of 0. This means that any distributions from the Dynasty Trust to beneficiaries two generations away or significantly younger nonrelatives will not be subject to GSTT. Further, the inclusion ratio is set at the time of the transfer so all future growth and appreciation of the assets in the Dynasty Trust will also be free from GSTT.



A Dynasty Trust is a great tool for leveraging your GSTT exemption because the exemption is applied up front and all future growth and appreciation in the assets will continue to be GSTT exempt.



The effect is that $10 worth of GSTT exemption ends up covering $20 worth of value transferred at a later date. This leveraging technique can be used with much larger gifts to Dynasty Trusts with assets that appreciate at rapid rates. The potential transfer value that can be protected from GSTT using this method is enormous.

THE TAKE-AWAY

With the proper timing, asset selection, application of the GSTT exemption, state governing law selection and careful drafting, the Dynasty Trust can be just as effective today as it was during the days of Rockefeller, Ford, and Carnegie. Dynasty Trusts are not proper for everyone but can be highly effective in the right scenario. Consider the following example which demonstrates the potential power of a Dynasty Trust.

Dynasty Trust Savings Example:

	Dynasty Trust	NO Dynasty Trust
Value Gifted	$5,340,000	$5,340,000
Appreciation Years 1-30 (6% Growth Compounding Annually)	$30,670,243	$30,670,243
Estate Tax Due at Gen. 1 (40% rate)	----------------	($10,132,096)
Amount at Start of Gen. 2	$30,670,243	$20,538,147
Appreciation Years 31-60 (6% Growth Compounding Annually)	$176,154,270	$117,960,666
Estate Tax Due at Gen. 2 (40% rate)	----------------	($45,048,265)
Amount at Start of Gen. 3	$176,154,270	$72,912,401
Appreciation Years 61-90 (6% Growth Compounding Annually)	$1,011,740,494	$418,771,731
Estate Tax Due at Gen. 3 (40% rate)	----------------	($165,372,691)
Final Amount at 4th Generation and 90 years	**$1,011,740,494**	**$253,399,040**

Tax Savings With Dynasty Trust Over 90 Years = $758,341,454