

An Overview of Family Legacy Trusts

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In the early 1900's, a handful of industrialists and entrepreneurs had amassed tremendous fortunes. John D. Rockefeller had made his name in oil, Henry Ford in automobiles, Carnegie in steel. Their estates, in today's dollars, would rival those of Bill Gates and Warren Buffett.

As these visionaries aged, most of them asked a handful of lawyers the same question: "What can I do to preserve my estate?" They knew that when they died, their estates would be heavily taxed when passing to children, and would shrink even more when going to grandchildren.

Using some of the most tax-savvy minds in the country, some of the most successful families created a separate trust... a legal entity designed to provide substantial assets to future generations, with little or no estate taxes. What they did, in the process, was create the "Dynasty Trust."

Introduction

In today's tax system, estate and gift taxes are levied every time assets change hands from one generation to the next. These dynasty trusts avoided those taxes by creating a second estate that could outlive most of the family members, and continue providing for future generations.

Dynasty trusts are long-term trusts created specifically for descendants of all generations. Dynasty trusts can survive until the “rule against perpetuities” invalidates the trust, which is different in various states. In Washington State, there is a flat 150 year limit for a trust. Many states have eliminated the rule, which allows perpetual trusts to be set up.

Saving on Gift Estate Taxes

There are no tax savings when you create a dynasty trust. Dynasty trusts are often funded using your Unified Credit (currently \$1 million per individual, \$2 million per couple).

The tax savings occur later at the deaths of your descendants. Even after the trust's assets have been accumulating for years, they remain free from federal gift and estate taxes for the life of the dynasty trust. That means no federal estate taxes on:

- Distributions from the trust to the grantor (the founder of the trust) or the grantor's descendants while the trust is in force;
- Distributions at the descendants' death while the trust is in force;
- Distributions of trust assets when the dynasty trust ends.

The estate tax savings can be enormous. Considering estate tax rates climb as high as 55%, and that tax is applied to each generation, you could end up saving up to 80% of your estate through three generations.

For instance, suppose you have \$1.00 now. Assuming an estate tax rate of 55%, that \$1.00 would shrink to 45 cents before it ever got into your children's hands. Now assume that their estate tax rate is 55% also. When your children die, that 45 cents will shrink to 21 cents! By the time your grandchildren see the benefits

of your lifetime of hard work, \$1.00 will only be worth \$0.21. To pass \$1 million on to your grandchildren, you would have to start with close to \$5 million.

That's where the dynasty trust comes in. That \$1.00 is not consumed by estate taxes, and is able to keep working for your heirs. In fact, let's assume a modest 6% annual rate of return. If your dynasty trust lasts for 100 years (which happens often), that \$1.00 would turn into \$339.30.

Which scenario would you want your grandchildren to have?

Limits on the Dynasty

In 1986, Congress (recognizing Uncle Sam was losing billions in estate taxes) attempted to thwart these transfers by creating the "generation-skipping transfer tax" (GSTT). The GSTT is applied to dynasty trust by assuming that the trust's beneficiaries own the assets in the dynasty trust outright.

However, Congress did include a significant exemption in the law. Every person has a GSTT exemption of \$1.1 million (\$2.2 million if married). That means each person can transfer up to \$1.1 million inside a dynasty trust, without any GSTT. Dynasty trusts of \$1 million or less offer the same gift and estate tax advantages of similar trusts created before 1986. The Taxpayer Relief Act of 1997 is indexing increases in the exemption to inflation.

Dynasty Continues On

The grantor's children are usually the preferred beneficiaries of a dynasty trust. After the last child dies, the grandchildren (or even great-grandchildren) become the preferred beneficiaries.

The dynasty trust, like any trust, has a trustee that controls it. The trustee can use trust income or principal for the benefit of the beneficiaries. When drafting a dynasty trust, you can determine just how narrow (or broad) the trustee's discretion is.

The dynasty trust can allow responsible beneficiaries to have complete control and access to their trust assets. For beneficiaries that are not as financially responsible, certain provisions restricting their access to trust income or principal can be incorporated into the trust.

By limiting beneficiaries' access, such "spendthrift clauses" can also prevent creditors of a beneficiary from attacking trust assets for indebtedness, or prevent the divorcing spouse of a beneficiary from laying claim to trust assets.

Starting a Dynasty Trust

Spendthrift clauses (as well as any dynasty trust) must be properly drafted by an experienced estate planning attorney. A knowledgeable attorney, who understands the grantor's situation, can also create discretionary clauses. Discretionary distributions can be conditioned on each beneficiary being able to support himself or herself on their own. With some many options, dynasty trusts can be tailored any way you choose.

The trust itself can be created during a grantor's lifetime, or a portion of the grantor's estate can be used to fund the dynasty trust at death. Creating a dynasty trust while alive allows the grantor to leverage his or her \$1 million GSTT exemption. The dynasty trust will shelter not only the value of the assets transferred inside it, but also any appreciation of those assets.

Funding The Trust

Dynasty trusts should only be funded with certain types of assets. The IRS taxes the income from these trusts very heavily (a flat 39.6%). As a result, the assets placed inside the dynasty trust must be tax-free, so as not to incur an annual tax bill. Non-dividend growth stocks, tax-free municipal bonds, and cash rich life insurance are suitable choices.

Many grantors choose to use their dynasty trust as an irrevocable life insurance trust. The trust is funded with insurance on the life of the grantor. When the grantor passes away, the proceeds of the policy pay any estate taxes on other assets in the grantor's estate. The cash-rich life insurance also provides an immediate death benefit and is self-completing. Using the dynasty trust as an irrevocable life insurance trust can provide excellent peace of mind.