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GUIDEPOST

Dynasty Trust Planning

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The term “dynasty trust” generally refers to a trust structured to last for a long duration, often as long as allowed by the governing state’s rule against perpetuities, or even perpetually, if allowed. Dynasty trusts are utilized to insulate trust assets from estate tax for multiple generations of beneficiaries. However, dynasty trusts provide other multi-generational benefits as well, including:

- Protection of trust assets from the creditors of the grantor and beneficiaries, including protection from an ex-spouse upon the grantor’s or a beneficiary’s divorce;
- For an individual residing in a state that imposes a state level income tax, income tax liability can be reduced by establishing a dynasty trust in a state that does not impose a state level income tax;
- Instilling and promoting long-term family values through incentive distribution provisions; and
- Ensuring family legacy assets remain in the family for multiple generations.

Creating a Dynasty Trust

A dynasty trust is simply an irrevocable trust structured to exist for a long duration. As such, a dynasty trust is created as any other irrevocable trust would be. To establish the trust, the grantor (also known as the donor, settlor or trustor) enters into a trust agreement with the trustee. The trust agreement names the beneficiaries and trustee(s), specifies trustee powers, stipulates the dispositive provisions of the trust (who gets what and when), and establishes rules for the administration of the trust. Any issue or question not specifically addressed in the trust document is generally governed by state law.

Trust Situs

The situs of a dynasty trust will be a key element in achieving the benefits afforded by a dynasty trust. A trust’s situs controls the state law that will be applied to the trust. Because state law can have a significant impact on the trust’s administration, careful consideration should be given to situs. The law of the state in which the trust is administered generally controls for all assets, except for real property which is generally governed by the law where the real property is located. Because a trust’s situs can have a significant impact on the administration of a dynasty trust, many dynasty trusts are drafted to give the trustee or another designated party the right to change the trust’s situs.

Rule Against Perpetuities

The duration of a dynasty trust is generally only limited by the governing state’s rule against perpetuities (RAP), which provides for how long a trust can validly exist. Most states’ RAP laws provide that an interest in a trust is invalid if that interest lasts longer than the lifetime of all individuals living at the time of the trust’s execution, plus an additional 21 years. Functionally, these RAP statues generally limit a trust’s duration to three generations. However, many states have extended the duration of their RAP to a set number of years, such as 360 (Tennessee) or 500 (Arizona) and some states have even eliminated it entirely (e.g., South Dakota). For individuals looking to establish a dynasty trust, utilizing a jurisdiction that has extended or eliminated its RAP will provide the greatest benefit.

State Income Tax

A trust’s situs will not impact the extent to which federal income tax is levied upon trust assets. However, choosing to situs a trust in a state with no state income tax can reduce income tax liability for individuals residing in a state with a state level income tax.

Drafting Flexibility into a Dynasty Trust

The longer a trust’s term, the more likely the objectives, financial circumstances and needs of the grantor and trust beneficiaries will change. Additionally, dynasty trusts often outlive the tax law applicable at the time of the trust’s execution.

Because the needs of the parties to the trust and tax law should be expected to change during the trust's term, it is necessary to ensure the trust is drafted to provide flexibility to adapt to changing objectives and laws.

Powers of Appointment

Beneficiaries can be given the power to redirect the distribution of trust assets through powers of appointment. Depending on the grantor's objectives, powers of appointment provided by the grantor can be exercised during a beneficiary's lifetime or upon his/her death (referred to as a testamentary power of appointment). The power of appointment can limit for whose benefit the power of appointment can be exercised. For example, powers of appointment can be limited to only the descendants of the grantor. A broader power of appointment may allow for distributions to anyone, other than the beneficiary, his/her creditors, or his/her estate. (Limiting a beneficiary's power of appointment in this manner avoids inclusion of assets over which the beneficiary can exercise the power in the beneficiary's estate). Powers of appointment often include charitable recipients and spouses of beneficiaries.

Decanting

Decanting a trust generally involves distributing the trust assets of one trust to another trust. If the trustee has discretion to distribute trust assets to a trust beneficiary, the decanting power allows the trustee to exercise the discretionary distribution power by distributing assets to another trust that benefits one or more beneficiaries of the first trust. Decanting powers can be created through state law, through the trust document, or through common law.

Amendment

A trust can give the trustee, trust protector, or another independent party the power to amend the trust's terms. The power of amendment can be limited to changing the trust because of administrative needs or changing tax laws. Alternatively, a broader amendment power can be granted, allowing for changes to the class of persons who are trust beneficiaries or distribution terms.

Fiduciary Provisions

Dynasty trusts should include detailed and thorough provisions regarding the appointment, removal and replacement of trust fiduciaries. These powers can be given to the trust grantor, trust beneficiaries, a third party, or some combination. (To avoid estate inclusion issues, a grantor's or beneficiary's right to remove and replace a trust fiduciary should be limited to someone not related or subordinate to him/her.) In some situations, it may be appropriate for a corporate trustee to serve and in other situations certain powers should be reserved for a corporate trustee and certain powers should be reserved for an individual trustee. Often, trust committees (which are comprised of individuals named in the trust or who will be designated according to the parameters as defined by the trust) are used to remove and appoint trust fiduciaries.

Contingent Beneficiaries

Since dynasty trusts are structured to last for multiple generations, the trust should name charitable beneficiaries or intestate heirs as ultimate beneficiaries in the event the intended beneficiaries (the grantor's children, grandchildren, great-grandchildren, etc.) all fail to survive while the trust is still in effect. Alternatively, a third party can be given authority to appoint assets to a charity or heirs.

Tax Considerations

Gift Tax

Like any gift to an irrevocable trust, a transfer to a dynasty trust for less than full consideration will be considered a gift to the trust. The annual gift tax exclusion amount allows a donor to give up to $17,000 (in 2023) to an unlimited number of recipients per year without being deemed a taxable gift. Assuming a gift to a dynasty trust qualifies as a "present interest" gift, the donor can utilize his/her annual gift tax exclusion to make gift tax-free transfers to the trust. Alternatively, an individual may utilize the basic exclusion amount (in 2023, $12.92 million) to make tax-free gifts to the trust.

Estate Tax

Assets owned by a properly administered dynasty trust can be excluded from the grantor's taxable estate. As a result, utilizing an irrevocable trust to own highly appreciating assets or life insurance can significantly reduce the grantor's exposure to estate tax liability.

Income Tax

For income tax purposes, a dynasty trust can either be a grantor trust or a non-grantor trust. However, since long-term accumulation is typically a goal of dynasty trusts, such trusts are often drafted to qualify as grantor trusts for income tax purposes. To qualify as a grantor trust, the trust must include certain provisions that result in the grantor (or another individual) being deemed the owner of trust assets for income tax purposes. If considered a grantor trust, the grantor must include all items of trust income, gain, loss, deductions, and credits in calculating his/her individual income tax liability. Grantor trust status, in effect, allows the donor to make additional "gifts" to the trust equal to the trust's income tax liability, without incurring additional gift tax. In addition, grantor trust status prevents transactions between the donor and the trust (i.e., the transfer of property and receipt of annuity payments) from being a taxable event.

If drafted as a non-grantor trust, the trust will be a separate entity for income tax purposes and trust income will be taxed according to trust tax laws. The trust will generally be considered either a simple trust or a complex trust. A simple trust distributes all income to trust beneficiaries and trust beneficiaries report their distributable share of income on their personal income tax returns. Complex trust rules typically apply where trust income is not mandatorily distributed to the beneficiary. With a complex trust, generally, income retained in the trust is taxed to the trust at trust rates and income distributed to a beneficiary (or for his/her benefit) is taxed to the beneficiary at his/her personal rates.

Generation-Skipping Transfer (GST) Tax

The GST tax exemption (in 2023, $12.92 million) may be significantly leveraged if applied towards the grantor's lifetime transfers to a dynasty trust. Typically, this is done by allocating the grantor's GST exemption to gifts made to the trust. If properly structured, the contribution can be transferred gift, estate, and GST tax free for multiple generations.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.18 million per person (approximately $22.36 million for a married couple). For assets transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40 percent. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation.

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