DYNASTY TRUSTS

(A general explanation)

Dynasty Trusts, also called Legacy Trusts, are set up to benefit future generations. Assets are transferred into the Trust and invested for many years so that future generations can enjoy financial benefits. For example, the Trust may be used for education, medical expenses (not otherwise covered by health or accident insurance), regular income, lump sum payments to purchase a home or start a business, protection against creditors and divorce, and many other uses.

The government does not like Dynasty Trusts in that the government does not collect estate taxes at each generation. However, value appreciation of the assets in the Trust can be protected from estate taxes. This is what makes the Dynasty Trust enticing to the taxpayers whose estates are large enough to be subject to estate taxes.

There are three tax traps with which we must deal – Estate Tax, Gift Tax, and Generating Skipping Tax. Income tax impacts are also described in this monograph.

1. ESTATE TAXES:

There is a federal estate tax, as well as an inheritance tax in some states. The tax depends on the size of the estate. Each taxpayer is allowed a lifetime exclusion. For example, if I die in 2013, the lifetime exclusion is $5,250,000. If my estate is less than this amount, there is no estate tax. (If a state imposes an inheritance tax, there is usually no state inheritance tax if there is no federal estate tax. However, some states may impose an inheritance tax even if there is no federal estate tax. Normally, a person’s residence determines the application of that state’s inheritance tax.)

Thus, there can be an estate tax imposed at each generation.

2. GIFT TAX:

What if we try to give away assets before death so that our estate is smaller and hence not subject to as much estate tax? Don’t count on it. The government will tax gifts so that we pay if we give it away or if we own it at death. The gift tax rates are about the same as the estate tax rates – very high.

There are some ways to make gifts (up to the limits) and avoid the gift tax. In 2013, we can give up to $13,000 per year to each person without any gift tax (and we do not have to file a gift tax return for these gifts).

And each of us has a lifetime gift tax exclusion of $5,250,000 (in 2012). We can give this amount without paying any gift tax (we must file a gift tax return to claim any part of this $5,250,000 exclusion).

Use of the gift tax exemption and exclusion will also reduce a person's estate tax exclusion in the same amount. Thus, if I have a $5,250,000 estate tax exclusion (the 2013 amount mentioned above), and if I make a gift of $5,250,000 using the full gift tax exclusion, then my estate tax exclusion will be reduced to zero. So, what good is making a substantial gift if my estate that is subject to estate taxes is not reduced?

The benefit is that if the $5,250,000 gift grows over the years, this growth will not be subject to the donor's estate tax. Thus, gifts keep future value appreciation out of my estate.

A husband and wife can make joint gifts to double up the exclusion. Thus, husband and wife can give up to $10,500,000 tax free using both of their lifetime gift tax exclusions.

Note: If there is a gift tax to be paid, it is owed by the person making the gift (donor), not the person receiving the gift (donee).

Of course lifetime gifts in any amount made to qualified charities are not subject to gift taxes. This is also true to avoid estate taxes on assets I own that are given to charities on my death.

3. GENERATING SKIPPING TAX (GST):

Someone may think that the way to avoid the estate tax at each generation is to give the assets to later generations (such as grandchildren or greatgrandchildren), thus skipping one or more generations. Not so fast, says the government. You can certainly skip a generation in making gifts or inheritances. However, if the government cannot collect an estate tax at each generation, they will collect a "generation skipping" tax at rates similar to rates for estate and gift tax.

As with the Gift Tax Exclusion of $5,250,000, I can claim a Generating Skipping Tax exclusion in the same amount.

Thus, a gift to grandchildren under $5,250,000 (if handled properly) can avoid gift taxes and GST. However, if the gift is greater than $5,250,000, then there will be a gift tax and GST on the excess over $5,250,000.

HOW CAN A DYNASTY TRUST AVOID THESE TAXES?

Say I have $1,000,000 in cash.

1. First I set up a Dynasty Trust with appropriate documentation;
2. I give this cash to the Dynasty Trust and use part of my lifetime GIFT TAX exemption so that I do not pay any gift tax;
3. Because the Dynasty Trust now owns the cash, the $1,000,000 is not in my estate – hence it is not subject to ESTATE TAXES when I die;
4. When the gift is made, I also claimed the GENERATION SKIPPING TRANSFER TAX exclusion;
5. Thus, there is no tax when the Dynasty Trust is set up and funded;
6. If no payments are made from the Dynasty Trust until I die, hopefully the value of the Dynasty Trust will be much larger than the initial $1,000,000. None of this increase in value will be subject to an estate or generating skipping tax., as it would be if I did not set up the Dynasty Trust.

And, for as long as the Dynasty Trust lasts there are no such taxes. Keep in mind that the maximum exemption is $5,250,000. Separate Trusts could be set up with separate gifts (ie, for different beneficiaries such as grandchildren) as long as not more than a total of $5,250,000 is gifted (adding up all separate gifts made). And, if the settlor has already "used" some of his or her lifetime exemption of $5,250,000, then what has been previously used must be deducted from the current gift. (NOTE: I can fund the Trust with more than the available gift tax exclusion if I am willing to pay the gift tax. This may be the way to go if assets can be transferred to the Trust that will greatly appreciate after the transfer (keeping in mind that the future appreciated value in the Trust is therefore free of estate, gift and generating skipping taxes).

And at my death I may be able to contribute even more to the Dynasty Trust. For example, say the estate tax exclusion is $5,250,000 when I die. During my lifetime I set up the Dynasty Trust with $1,000,000 (using my gift tax exclusion, which also reduced my estate tax exclusion by the gift of $1,000,000. Therefore, at my death my estate tax exclusion is $4,250,000. In my Will I give $4,250,000 to the Dynasty Trust. There is no estate tax on this $4,250,000 (which is the remainder of my estate tax exclusion). This testamentary gift also qualifies for the Generating Skipping Tax exclusion (the exclusions for both estate tax and generating skipping tax are the same amount). However, there may be estate taxes on the rest of my estate, if not given to my spouse or to charities.

A word on INCOME TAX. The Dynasty Trust is a separate tax entity (it is an irrevocable trust), and therefore must report and pay income taxes (on interest, dividends, rents, etc that it earns from the assets in the Trust). If the beneficiaries are paid from the Trust during the year in which the income is generated, the income may be taxed to those beneficiaries rather than to the Trust. The tax rates for a trust are normally higher than for an individual beneficiary.

WHO CONTROLS THE DYNASTY TRUST?

The simple answer is the Trustee. But who is the Trustee?

The Trust is set up by the person who initially funds it. He or she decides what the Trust Agreement (the operating document) says. However, the control must be in a trustee who is not the original settlor, nor controlled by the settlor. It can be an individual, but is often a financial institution (such as a bank or company with trust powers) which can carry on the long-term Trust. Thus, once set up, the original settlor looses control (this is how it becomes exempt from the estate taxes). The Trust Agreement identifies the beneficiaries and when they can receive distributions from the Trust. The Trustee follows the terms of the Trust.

The Trust is irrevocable, and cannot be changed by the Settlor. In rare situations, a court can become involved to change the terms of the Trust – such as when a situation arises that was not contemplated by the Trust Agreement.

ARE WE LIMITED TO $5,250,000 IN SETTING UP A DYNASTY TRUST?

The $5,250,000 (2013) is the maximum opening balance in the Trust (anything greater will cause gift taxes to be paid). If the value of what is in the Trust grows over the years before it is paid out to beneficiaries, the Trust "corpus" can grow very large – many millions. This growth is not subject to gift tax, estate tax or generating skipping tax, but can be subject to income tax as explained above.

The Trust can buy assets. For example, I set up the Dynasty Trust with $1,000,000 in cash. And I have other assets (say an apartment building) currently worth $5,000,000. I sell my apartment building to the Trust for $5,000,000, collecting 20% down (getting back the $1,000,000 in cash) and then holding a Seller carry-back loan for the balance of $4,000,000. The Trust uses the income from the apartment building to make payments to me. (Note: the $4,000,000 loan is part of my estate and the balance due on the loan may be subject to estate tax if I die before the loan is paid off.) As the loan is paid to me, the $4,000,000 plus interest on the loan will be in my estate if I have not spent it, or given it to charity. However, the big benefit is that as the apartment building appreciates in value over the years, this increased value is not part of my estate. Ultimately, the loan will be paid off, and the Trust will own an asset worth greatly in excess of $5,000,000. Caveat: interest must be paid on the loan at no less than Applicable Federal Rates (AFR).

DOESN'T THE INCOME TAX ON THE TRUST CREATE A PROBLEM?

Irrevocable trusts normally pay income taxes at higher rates than individuals. So, if there is taxable income, it is a good idea to not have the Trust pay the income tax. A way to avoid this is to initially create the Trust as an "Intentionally Defective Grantor Trust" (IDGT). This is done by including in the Trust Agreement that the original Settlor has certain powers (such as the right to substitute assets in the Trust). Then, the IRS will disregard the Trust as a separate tax entity, and tax the initial Settlor on all income as though the Trust did not exist. This is the same way revocable living trusts are treated prior to the death of the Settlor.

So, in our example of the apartment building, all rental income would be taxed to the Settlor, but no income would be reported by the Settlor for the interest paid on the Seller carry-back loan. Although the Settlor would pay income taxes as though he or she still owned the assets, the benefit is that the Trust "corpus" can grow that much faster because it does not pay income taxes. The transfer of the asset to the Trust is not a sale (no capital gain treatment), and the Trust income tax basis in the asset is the same basis as the Settlor.

If the Trust (qualified as IDGT) sells the asset, the Settlor reports the sale using his/her own basis for capital gain purposes. And, upon Settlor's death, there is no stepped-up basis on the assets in the Trust. (NOTE: Prior to Settlor's death, he/she can exchange an asset they own, that has not appreciated, for the Trust's highly appreciated assets. Then, upon Settlor's death the highly appreciated asset would get a stepped-up basis because is it in the Settlor's own estate, not in the Trust. Butif the Trust sold the less appreciated property it then owns, there would be less capital gains tax to pay.)

As can be seen, setting up and funding a Dynasty Trust can be very complicated. Experts in trust law, taxes and financial planning must be utilized and coordinated. They will know if the tax and trust laws have changed, that might limit or eliminate the advantages of a Dynasty Trust.

MESSAGE: This Information Sheet is intended to provide general information only. It is not intended to cover all of the legal issues that arise in each situation. It is suggested that none of the documents described above should be signed without first talking to an attorney who is knowledgeable about such matters. This material is dated and the enclosed information may change because of new laws, regulations, or other impacts.

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