1. Introduction
This issue will examine the estate planning concept known as the Dynasty Trust. The Dynasty Trust, sometimes known as a perpetual trust, has become a popular method for effecting legacy goals that call for distributions not only to a person’s children and grandchildren, but to succeeding waves of future descendants for as long as the trust has assets and the law allows. It shares the basic estate tax and legal characteristics of the more common irrevocable trust but welds to it a capability for enforcing the grantor’s distribution and legacy goals beyond the normal trust’s life span. As discussed below, a properly drafted, funded and operated dynasty trust can be a powerful and tax-efficient tool for effecting a client’s financial objectives. Dynasty Trusts are complex and it is important that client’s confer with their independent tax and legal advisors about this estate planning technique.

2. What is a Dynasty Trust?
The Dynasty Trust is an irrevocable trust designed to benefit multiple generations by allowing for the continued use of assets held in trust. Designed to provide for the grantor’s descendents with minimal loss for transfer taxes, the Dynasty Trust can be distinguished from the typical irrevocable trust by its multi-generational approach to legacy planning and its sensitivity not only to estate and gift tax concerns but also generation-skipping transfer (GST) tax.¹

¹The term “Dynasty Trust” does not have a specific tax or legal definition. It is a marketing term. However, it implies an intent to preserve the grantor’s wealth for his or her descendents (the dynastic element) beyond the lives of his or her children and grandchildren. Consequently, in tax terms, the Dynasty Trust will always be classified as a generation skipping trust. For purposes of this article, the term “GST” refers to a generation-skipping transfer.
**Common Features**

Like most trusts, a Dynasty Trust document addresses a number of items, including: (1) who are the trust beneficiaries, (2) how long the trust will last, (3) who will be the trustees and successor trustees, (4) what procedure and terms will be followed for lending funds to the beneficiaries, (5) what discretionary powers will be given to the trustee to manage and distribute income and principal, (6) how loans from the trust will be repaid (or not be repaid because the Trustee forgives them), and finally, (7) what happens when the trust terminates, possibly several generations later.

Clients who establish dynasty trusts often have multiple goals. They are focused on transferring their wealth to their heirs. They want to maximize the inheritance they leave for future generations. They want to minimize estate and other transfer taxes and may want to provide liquidity for projected estate settlement costs. They may also wish to encourage their heirs to be productive members of society and to preserve their family values. In addition, they would like to protect their heirs from creditors and divorce.²

**Duration**

Dynasty Trust instruments typically allow the trust to continue for as long as the governing jurisdiction allows. Thus, the duration of a trust is effectively limited either by the rule against perpetuities or by a statutory maximum.³ In most states, the rule against perpetuities prevents the grantor’s trust from holding and controlling the grantor’s assets for more than twenty-one years after the death of the last surviving beneficiary (who was living at the time the trust was created).⁴ In some states, the rule against perpetuities has been replaced with a different limit. For example, states adopting the Uniform statutory rule enforce a limit of 90 years. Still other states have statutorily abolished the rule against perpetuities without imposing an alternative limit. In these states a trust’s duration is not limited – a trust could go on ‘forever’ or ‘in perpetuity’. A trust established in one of these states may continue until all funds are distributed or until there are no living descendants of the grantor.⁵ While intended to last as long as possible, most Dynasty Trusts contain a protection clause designed to prevent a violation of the applicable duration limit.

**Tax Characteristics**

As with other estate planning irrevocable trusts, a dynasty trust’s primary tax purpose is the reduction or avoidance of transfer taxes that would otherwise reduce the legacy provided to the grantor’s heirs. For estate and gift tax purposes, a Dynasty Trust will operate just as any other irrevocable trust. Thus, for example, gratuitous transfers made to a Dynasty trust will generally be treated as completed gifts. As in other estate tax avoidance trusts, a Dynasty Trust should be drafted so that its assets will not be included in the grantor’s or grantor’s spouse’s estates.

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² Creditor protection laws vary dependent upon governing federal and state law. The applicability of such laws also depends on the terms of the trust. One should be sure to confer with an independent tax and legal advisors prior to establishing a trust for this purpose.

³ The rule against perpetuities is a common law rule which generally provides that no interest in property is valid unless it must vest, if at all, within a life or lives in being plus 21 years (and gestation periods).

⁴ The following list includes some of the states that have either abolished or modified the common law rule against perpetuities: Alaska, Arizona, Delaware, Florida, Idaho, Illinois, Maine, Maryland, Ohio, Rhode Island, New Jersey, South Dakota, Virginia, Washington, and Wisconsin.

⁵ See e.g., South Dakota, Maryland, Delaware, New Hampshire
For income tax purposes, these trusts will either be taxed as grantor trusts under IRC §671-679 or as separate taxable entities, in which case income will be taxed to and paid by the trust itself, at the published trust tax rates. Many tax advisors recommend the use of provisions that will confer grantor trust status so that certain additional estate planning advantages may be gained, for example:

- payment of income tax by the grantor to further the trust’s effective rate of investment return;
- the ability to buy existing life insurance policies without violating the transfer for value rule
- the use of an estate freeze technique known as a sale to an intentional defective grantor trust.

A complete discussion of the grantor trust considerations is beyond the scope of this article. However, a past issue of *Legal & Tax Trends* covers this matter in detail.

Grantors who establish Dynasty Trusts employ many of the same techniques common to “non-dynastic” estate planning, such as systematic use of one’s annual exclusions for gift tax purposes and lifetime gift tax exemption. However, because it is by definition intended to benefit the grantor’s grandchildren and more remote descendants, a dynasty trust must also be sensitive to generation skipping transfer (“GST”) tax issues.

The GST tax imposes an extra layer of transfer taxes at a rate equal to the maximum estate tax rate when assets are given to grandchildren, either directly or from a trust. While a full discussion of the generation skipping transfer tax is beyond the scope of this article, some principles are important to note. When property is distributed to a grandchild or more distant heir (a “skip person”), unless the trust is GST-exempt, the GST tax will generally apply. Transfers from a non-GST exempt trust benefiting children and grandchildren (and more remote generations) generally will be subject to GST tax either when a distribution is made to a grandchild or when there are no surviving beneficiaries in the children’s generation, whichever is earlier. Transfers to trusts whose beneficiaries are all in the grandchildren’s generation (or lower) are subject to GST tax immediately upon transfer.

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6 The GSTT applies to transfers made after October 22, 1986. A “direct skip” is a transfer to a skip person, a person two or more generations below the donor, that is subject to federal estate or gift tax. When a grandparent writes a check to a grandchild or when grandparent bequeaths property to grandchild, grandparent’s transfer is a direct skip. See IRC § 26.2612-1(a).

7 IRC § 2613(a) defines a skip person as either (1) a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or (2) a trust, if all interests in such trust are held by skip persons, or if at no time after the transfer may a distribution be made to a non-skip person.

8 Where there is a GST taxable distribution to a trust beneficiary, he or she is liable for the GST tax. IRC § 2603(a)(1). Where a taxable termination occurs (i.e., upon the death of the last of the intervening children’s generation) the trustee is liable for the GST tax. IRC § 2603(a)(2).

9 Where a grantor makes a gift to a trust benefiting only grandchildren (and more remote descendants) the transfer is considered a “direct skip,” and the transferor is liable for any GST tax. IRC § 2603(a)(3). For GST tax purposes, if a trust that has any non-skip beneficiaries (e.g., the grantor’s child) becomes a trust with only skip beneficiaries (e.g., grandchildren), a taxable termination occurs. See IRC § 2612(a)(1).
In 2015, each taxpayer has the use of a $5.43 million GST tax exemption to offset the otherwise harsh effect of the tax.\textsuperscript{10} In the context of trusts, GST tax planning involves the allocation of this exemption in a way that preserves the trust's status as either wholly exempt from GST tax (i.e., no distributions are GST taxable) or wholly subject to GST tax at the time of funding.\textsuperscript{11} Consider the following simplified examples, which assume that the grantor has full use of his or her GST tax exemption. Please note that these examples do not address any estate or gift tax issues, only the GST tax impact.

**Example:** Assume that Rick, who is unmarried, creates and funds an irrevocable trust for his grandchildren with a transfer of $9 million in 2015. Rick makes no other gifts to the trust. The transfer is subject to GST tax at the time of transfer since the trust only benefits “skip persons.” Rick may allocate his $5.43 million GST tax exemption to the transfer to avoid some of the GST tax. He will still pay GST tax on $3.67 million at the applicable rate. Future trust distributions of income, growth, or principle to Rick’s grandchildren will not be subject to GST tax.

**Example:** Assume Philip, who is unmarried, creates and funds an irrevocable trust for his only child and grandchildren with a transfer of $10 million in 2015. He makes no other gifts to the trust. Because his child is a beneficiary, the GST tax does not apply at the time of his gift. However, because in 2015 Philip only has $5.43 million of GST tax exemption, nearly half of his $10 million gift was “unprotected” from future GST tax inclusion. As a result, this trust’s GST tax inclusion ratio is 46.7% ($6.67m divided by $10m). While his child is alive, when distributions are made from the trust to his grandchildren, just under half of each such distribution will be subject to GST tax. Upon the death of his child, half of the remaining value of the trust will be subject to GST tax.

**Example:** Assume Mirasol, who is unmarried, creates and funds an irrevocable trust for her children and grandchildren with a transfer of $5.43 million in 2015. Mirasol makes no other gifts to the trust. Because her children are beneficiaries of the trust, the GST tax does not apply at the time of her gift. However, in order that future distributions from the trust not be subject to GST tax, Mirasol allocates her entire GST tax exemption to the gift. Because the entire transfer to the trust was “protected” by her exemption allocation, this trust is wholly exempt from GST tax.

\textsuperscript{10} The GST tax exemption is equal to the estate tax exemption amount ($5,000,000 in 2011 adjusted for inflation after 2011).

\textsuperscript{11} In tax parlance, an irrevocable trust which will not be subject to GST tax at termination (or distribution) is said to have a “zero inclusion ratio.” The inclusion ratio represents the fraction of each taxable distribution (or termination) that will be subject to GST tax. The formula for calculating a trust’s inclusion ratio is outlined in the Regulations to IRC §2642: the numerator is the amount of the GST tax exemption allocated to the trust; the denominator is the value of the property transferred to the trust (or involved in the direct skip), reduced by the sum of: (a) any federal estate tax and state death tax attributable to, and recovered from, the property, and (b) any estate or gift tax charitable deduction allowed with respect to the property. The resulting ratio is then subtracted from 1 to establish the inclusion ratio. An inclusion ratio of 0 means no part of the interest in trust is subject to the GST tax; a ratio of 1 means the entire interest is subject to the GST tax; and a ratio in between means that a portion of each distribution (or of the whole trust amount upon a termination) will be subject to the GSTT. Treas. Reg. §26.2642-1.
Example: Assume Roxanne would like to leave a $9 million bequest in trust to her child and her grandchildren. Her advisor suggests that her will create two trusts, one to be GST tax exempt, and one to be GST tax non-exempt, to be apportioned as to make the best use of her remaining GST tax exemption. Having made some other gifts, Roxanne dies with $5 million of GST tax exemption, so her executor allocates exactly $5 million of assets to one trust (the exempt trust) leaving $4 million for the other. Roxanne’s child takes distributions as necessary from the non-exempt ($4 million) trust since at his death the remaining balance will be subject to GST tax. He does not take distributions from the $5 million exempt trust since it may pass to Roxanne’s grandchildren without incurring GST tax.

The long-term perspective of the Dynasty Trust, coupled with its appealing tax reduction and flexible distribution opportunities make this planning technique very attractive.

3. Why Create a Dynasty Trust?
Dynasty Trusts are often created by clients to achieve a broad spectrum of personal, financial, and tax goals. These goals often include one or more of the following:

1. Creating as much long term wealth as possible;
2. Benefiting many successive generations of family;
3. Creating investment liquidity;
4. Holding and maintaining special family assets for as long as possible;
5. Benefiting family members while still preserving family values;
6. Protecting trust assets from creditors;
7. Protecting trust assets from divorced spouses; and
8. Avoiding multiple levels of federal and state estate and gift tax.

The basic design objective of a Dynasty Trust is quite simple. It is designed to be able to last as far into the future as possible in the most efficient manner possible from a transfer tax perspective. Through strategic use of transfer tax exemptions, the value of the funds ultimately received by the trust could grow several times larger than the property could have grown had it been directly distributed to each successive generation.

The basic financial objectives of a dynasty trust depend on the goals of its creator. In most cases, the impetus for using the dynasty trust, as opposed to another irrevocable trust, springs from the multi-generational (i.e., long-term) characteristics of the trust. Based on its potential for compound asset growth over several generations and due to its unique ability to avoid wealth transfer taxes at each successive generation, a dynasty trust appeals to grantors who perceive the financial security it can provide to the grantor’s heirs as a precious commodity. In short, it fulfills the goal of creating a fund to benefit future generations of family members.

The appeal of the dynasty trust may also be understood when considered from the beneficiaries’ perspective. One such example is when the trust permits loans to be made to beneficiaries without their having to submit financial statements or prove their creditworthiness. In fact, funds might even be available to beneficiaries when traditional financial institutions may otherwise reject their loan application. Under certain circumstances, beneficiaries may be able to receive outright distributions from the trust. For example, trust funds could be used to pay for a child’s education or for a beneficiary’s own medical needs. Or perhaps, the trust provides
supplemental income, allowing the beneficiary to engage in a profession or career that, while less remunerative than others, is nevertheless how he or she prefers to spend his or her life.

The implicit comparison to a bank is instructive, as the dynasty trust shares with a true bank the proximate goals of accumulating, managing, preserving and distributing wealth. You could view this type of trust as a “family bank” because, like a bank, it can be a prime resource for funding the financial needs of members of the grantor’s family for successive generations. Of course, a dynasty trust is not actually a bank, yet it could become the friendliest “bank” the trust beneficiaries might ever know.

Although the above-mentioned bank imagery is particularly “liberal” in its approach to distributions to beneficiaries, a dynasty trust can just as easily be “conservative” in operation. The specific goals of a particular grantor may be reflected in the dispositive provisions of that grantor’s trust. Generally, the more guidance and flexibility given to the trustee, the more likely the trustee will be able to accomplish the grantor’s intent. Consider a grantor interested in helping her descendants while avoiding the dangers of privilege (as in goal #5, above). After all, the beneficiaries might be people unknown to the grantor. They might not even be born yet. So as not to spoil them, or in some way eliminate their incentive to work or be productive members of society, the trust could be drafted to create restrictive distribution provisions, provide incentives for desirable behaviors, include tight spendthrift provisions, and even create a charitable giving component.

A dynasty trust could even include more specific goals, as where the grantor desires that the trust provide for the higher education expenses of every grandchild and great-grandchild. The grantor could accomplish such a goal by direct instructions to the trustee, as set forth in the document itself, regardless of whether the trustee is a family member and beneficiary or an independent trustee.

A dynasty trust’s purposes may also include the goal of creditor protection for the beneficiaries; protection from creditors, predators, divorced spouses, former business partners, or from the beneficiary’s own financial immaturity. Depending on the terms of the trust and flexibility provided to the trustee, the dynasty trust can act like a sword and a shield. As a sword, it can separate the beneficiary from taking control of his or her inheritance too soon. This is especially useful when the beneficiary is a minor or is too financially immature to manage the assets. As a shield, it can protect the beneficiary and protect the inheritance from others.

The use of a dynasty trust may be appropriate where the grantor owns a family-run business that the grantor expects to be run for many years by family members (current and future). In this situation the overriding goal of the dynasty trust might be to maintain integrity of ownership (i.e., avoid fracturing ownership into many minority holdings). The trust arrangement could allow the business interests to be owned “beneficially” by all trust beneficiaries even though some of them may not work in the business. Similarly, a vacation home could be placed in a LLC and the membership interests could be gifted to the dynasty trust. The dynasty trust could

12 Thus, for example, should a beneficiary seek financial assistance from the dynasty trust to fund a new business venture, per the terms of the document, the independent third party trustee may require a business plan.

13 In the case of business that is a going concern, it is generally preferable for the trust to have an interest in an LLC (or like entity) which, in turn, owns the business. The same may apply to commercial real estate holdings, for example. In both instances, it might be too difficult to divide up the ownership and management of the property among so many beneficiaries – even though the grantor desires that they all own and benefit from these assets equally.
include a provision for perpetual funding of maintenance and taxes so that future members of the family could enjoy meeting and spending time together there.

4. Funding Considerations
Dynasty trusts normally have the same investment opportunities as individuals. Therefore, it’s possible for a dynasty trust to hold just about any type of asset, including traditional financial assets (such as stocks, bonds, mutual funds, options, commodities and derivatives), interests in residential and commercial real estate, interests in a business (including a family business) and individual and second to die life insurance.

What is the best way to build long term wealth in a dynasty trust? While the specific goals of a particular trust will determine the optimal mix, the principle of balancing risks with investment performance will drive the investment decision of most trustees. In order to best achieve the grantor’s accumulation and distribution objectives, each applicable risk that might impact the dynasty trust should be understood; asset selection should proceed with a mind to minimizing or offsetting these risks.

Income tax risk often presents a significant threat to achieving a successful outcome in dynasty trust planning. The more successful the trustee is in achieving the client’s tax objectives, the more likely the trust will succeed in achieving its long term financial and legacy goals. Consequently, many estate planning professionals encourage their clients to select a jurisdiction whose income tax laws are favorable and well understood to govern their client’s trust. Similarly, they often encourage their clients to appoint a professional trustee (or co-trustee) in the jurisdiction in question to manage the investments so that the trust does not incur unnecessary income tax.

However, even if tax the income risk is minimized or eliminated, a client’s dynasty trust planning goals might still not be achieved due to a number of other risks. Market risk, for example (i.e. the risk that, at any time, the trust assets could decline in value) could seriously impair the trust achieving its objectives. Mortality risk (i.e. the risk that the client will die early) could shorten the number of years the client has to make gifts to the trust as well as hasten the time when the family starts needing the funds set aside in the trust (to support the family lifestyle or to pay estate taxes).

Each trustee is responsible for deciding what assets the trust should own. For some dynasty trusts, part of the decision may be made for the trustee, in the form of a specific instruction to maintain certain property (e.g. the trustee must maintain a specific family vacation house or must retain ownership of certain business stock). Specific distribution objectives may also lend themselves toward particular investment strategies. For example, if a trust were required to distribute a specified amount of money each year, the trustee might consider a blend of income producing assets (bonds, CD ladders, dividend-paying stocks) and not an investment in unimproved real estate. Absent such explicit investment direction, the trustee will be required to match the interests of the beneficiaries (i.e., the distribution objectives of the grantor) with his or her responsibilities under the Prudent Investor rules.

5. Drafting Considerations
Insofar as a dynasty trust is a type of irrevocable estate planning trust, most of its terms will resemble the terms one expects in such a traditional trust. However, the application of GST tax considerations, the extended duration, and other distinguishing elements require special
considerations by the client’s attorney and tax advisor. While it is beyond the scope of this newsletter to address all such issues, some are discussed below.

**Income Tax**

In the estate planning context, many attorneys recommend using irrevocable trusts that are grantor trusts for income tax purposes.¹⁴ As a result, a dynasty trust will often be drafted as a grantor trust. Grantor trust status benefits include maximizing the accumulation of income in the trust (through grantor’s payment of income tax on trust earnings), grantor’s ability to substitute assets (thereby retaining an asset-specific form of control), and the ability to change life insurance policies should circumstances change.¹⁵ Grantor trusts also may be required for some advanced giving and estate freeze techniques such as the sale to an Intentionally Defective Grantor Trust (IDGT) or private premium financing of life insurance.

While income accumulation may be the primary goal of most dynasty trusts during the grantor’s life (and often the children’s lives), drafters should consider allowing discretionary distributions of income to the children’s generation where significant income tax reduction is possible (i.e., where children will pay tax on distributed income at a much lower rate).¹⁶ Of course, the tax considerations should not override the non-tax dispositive goals of the grantor. Even within the tax discussion, the GST and estate tax benefits may outweigh the considerations regarding potentially high trust (or grantor) income taxes paid.

Given the duration of a typical dynasty trust, state income taxes over the long term can limit the accumulation potential of a trust. Consequently, the state income tax of the trust situs will be an important factor in deciding on the trust’s situs.

Similarly, drafters should consider allowing limited distributions of principal to the children’s generation. While uncommon, the ability of the trustee to distribute principal to a child would allow the property so distributed to receive a step-up in basis at the child’s death. Obviously this defeats the purpose of the dynasty trust – in terms of control/direction by the grantor, as well in transfer tax terms – but in some cases the flexibility might be warranted if the income tax savings are significant.

In the event that a dynasty trust becomes subject to GST tax (i.e., has an inclusion ratio greater than zero), a distribution to a skip person will be subject in whole or part to GST tax. The GST tax paid by such an income beneficiary with respect to the distribution will be eligible for a deduction for income tax purposes.¹⁷ This deduction is similar to the IRD deduction for estate taxes paid which is available to beneficiaries of the estate.

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¹⁴ For more information on the income tax and estate planning opportunities available through the use of grantor trusts, please refer to the *Legal & Tax Trends* newsletter titled *Grantor Trusts and IDITs*.

¹⁵ The ability to change life insurance policies derives either from the trust’s ability to buy existing policies without causing a transfer for value. See PLRs 200247006 and 200228019 where grantor trusts acquired policies without incurring a transfer for value.

¹⁶ Whether or not the trust is subject to GST tax, a trust that allows for distributions of income may elect to have distributable net income (DNI) carried out to the beneficiary receiving such a distribution.

¹⁷ IRC §164(a)(4).
**Coordination with the Gift Tax**

The gift tax annual exclusion for transfers in trust (i.e., Crummey gifts) is not coordinated with the GST annual exclusion for direct skips, with one exception. Specifically, if a donor makes a nontaxable gift (which is a direct skip) to a trust for the benefit of an individual, this transfer is subject to the GST tax unless: 1) during the lifetime of the individual, no corpus or income may be distributed to anyone other than the individual; and 2) if the individual dies before the termination of the trust, the assets of the trust will be included in the gross estate of the individual. Thus, while a gift in trust may qualify for the gift tax annual exclusion, the same gift typically will not qualify for a corresponding exclusion from GST tax.

**Example:** Kelly creates a trust for his Son and Grandson in which both beneficiaries have Crummey withdrawal rights. The trustee has discretion to pay income and/or principal to either beneficiary. Kelly’s gift to the trust may be sheltered from gift tax under the annual exclusion, but the transfer is not a direct skip – and cannot therefore be protected by the GST “annual exclusion” – because a non-skip person (Son) has an interest in the trust. Kelly must allocate GST tax exemption to the gift in order to preserve the trust’s inclusion ratio of zero.

For trusts with multiple beneficiaries, as are most dynasty trusts, this means the grantor’s GST tax exemption should be allocated to every transfer, even where the gift qualifies for gift tax exclusion.

The potential application of GST tax will also affect the drafting of the Crummey withdrawal provision. Where a certain beneficiary has a right to withdraw an annual gift but chooses not to exercise that right, the amount not-withdrawn will be treated for tax purposes as a gift by that beneficiary to the other trust beneficiaries. There is an exception from this treatment for an amount equal to the greater of either $5,000 or 5% of the trust value. The amount of this exception is known colloquially as the “5 & 5 amount.”

**Example:** In $2015, Salina creates a trust for her son Ahmad and her daughters Irene and Ellen. She transfers $14,000 to the trust, bringing the trust’s value to $100,000. Under the terms of the trust, Ahmad has the right for 30 days to withdraw the $14,000. He does not withdraw any of the $14,000. After 30 days, when the withdrawal right lapses, Ahmad will be treated as having made a gift of $9,000 to his sisters. The lapse of the first $5,000 of the $14,000 gift is not treated as a transfer by him because the “5 & 5” lapse power exclusion.

For GST tax purposes, when a withdrawal right amount in excess of $5,000 (or 5%, if greater) lapses, the beneficiary who held the right is treated as the transferor of that lapsed amount.

**Example:** Assume the same facts as in the example above. The trust will invest principal for the benefit of Salina’s descendants in perpetuity. For GST tax purposes, Ahmad will be treated as the transferor of $9,000 to the trust. In order for the trust to preserve the inclusion ratio of zero, Ahmad will have to allocate some of his GST tax exemption at the time the gift lapses.

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18 IRC § 2642(c)(2)
19 IRC § 2041(b)(2)
20 Reg § 26.2652-1(a)(5), Ex 5
Example: GF creates a trust for C and GC and transfers $22,000 to it giving each the power to withdraw $11,000. C’s failure to withdraw constitutes a lapse, making C the transferor with respect to the $6,000 excess. GF would be the transferor of the difference. C would have to allocate $6,000 of his GST tax exemption to the trust to give it an inclusion ratio of zero. The fact that C becomes transferor may have no practical effect if the trust will never benefit any generation below that of GC. But if this were a dynasty trust designed to last for the maximum period, GST tax could ultimately apply.

For dynasty trusts, some drafters limit a beneficiary’s withdrawal rights not simply by the gift tax annual exclusion ($14,000 in 2015) but also by the “5 & 5” lapse amount. Where withdrawal rights are also limited to the greater of $5,000 or 5% (of the trust value) per person, the lapse of such a power will not require a GST tax exemption allocation by the withdrawal beneficiary. Note that a release of such a power is not treated as a lapse. A release will be treated as a transfer by the withdrawal power-holder to the other trust beneficiaries.

Other drafters prefer to allow a beneficiary to have a continuing right to withdraw a given amount under a so-called “hanging power.” Typically such continuing withdrawal powers apply to any amount above the “5 & 5” amount mentioned above. Where the trust grants such hanging powers over excess gifts, the transferor can still allocate GST tax exemption at the time of transfer. However, if the beneficiary holding the hanging power dies, that beneficiary will become a transferor for GST tax purposes over the hanging amount. This means, in effect, that some of the GST tax exemption allocation (i.e., protection) made by the original transferor will be eliminated. To address this concern, some drafters have the trust distribute the hanging amount to the deceased beneficiary’s estate. Others plan to let the hanging powers lapse, but allocate the GST exemption of the deceased beneficiary to the lapsed amount in the year of the beneficiary’s death.

In practical terms, the importance of preserving a zero inclusion ratio for a dynasty trust will require the drafter either (a) to further limit the amount of each gift subject to withdrawal powers, (b) plan that each beneficiary (even those of the children’s generation) receive distributions of any hanging power amount, or (c) plan to use a beneficiary’s GST exemption at the appropriate time.

Generation-Skipping Transfer Tax
For lifetime transfers, GST tax exemption will be allocated automatically to each transfer to a “GST trust” unless the transferor elects out of the automatic allocation rule. The use of the “GST trust” definition is, in the words of one commentator “somewhat crude” however, and many advisors recommend an affirmative allocation of GST exemption in dynasty trust situations instead of relying on the automatic allocation.

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21 Note that a release of such a power is not treated as a lapse. A release will be treated as a transfer by the withdrawal power-holder to the other trust beneficiaries.

22 Note also that the amount subject to the hanging power will be included in the power holder’s gross estate for estate tax purposes. IRS Letter Ruling 9643013.

23 See §2632(c)(1). “GST Trust” as defined in §2632(c)(3)(B) is any trust that could have a generation-skipping transfer occur with respect to the transferor, with certain exceptions.

24 EGTRRA introduced IRC §2632(c) to expand the deemed allocation provisions to include lifetime transfers to trusts presumably intended to remain exempt from GST. These provisions were extended permanently under the American Taxpayer Relief Act of 2012.
The GST tax exemption may be allocated to direct gifts to a dynasty trust, but trust funding via certain split interest gift techniques requires waiting until the dynasty trust receives the asset. In short, GST tax exemption cannot be allocated until the close of the estate tax inclusion period (ETIP). This refers to a transfer that is a completed gift for gift tax purposes, but in the event of the transferor’s death, the value of the property will still be included in the transferor’s estate. The most common example of this limitation in the dynastic context may be seen in the use of GRATs to fund a dynasty trust. While a transfer to a GRAT may be a completed gift for gift tax purposes, the asset will be included in the estate of the grantor if the grantor should die during the trust’s term. The grantor may not allocate GST tax exemption to the GRAT at the time the GRAT is funded, but must wait until the end of the trust term.

For GST tax purposes, charities are considered non-skip persons assigned to the transferor’s generation. However, having a charity as a beneficiary of a dynasty trust will only affect GST tax considerations if the charity has the non-discretionary right to receive income or principal. Since in most dynasty trust designs the charity will only be a contingent remainder beneficiary (the proverbial “taker of last resort”), the presence of the charity as a beneficiary will not impact the GST tax. Where a grantor would like the charity to benefit in a more definite way, it will typically be more tax-efficient for the transferor to use another mechanism to accomplish the charitable goal, instead of using one’s exemptions to protect gifts to charity that would not have needed such allocations had the gifts been made directly.

**Estate Tax**

Any trust that qualifies for the estate tax marital deduction will treat the spouse of the grantor as the transferor for GST tax purposes, with the important exception of the QTIP trust. A so-called “reverse QTIP election” will allow the original transferor to be treated as the transferor for GST tax purposes, even though the QTIP property will be included in the gross estate of the spouse-beneficiary for estate tax purposes.

Life insurance on the life of a beneficiary may cause inclusion in the estate of the beneficiary under IRC §2042 unless the trust properly insulates such beneficiary from control over the policy. The insured beneficiary may not be trustee and may not have either a general or a limited power of appointment over the trust property. In the dynasty trust context this issue may arise if the child of the grantor is a beneficiary of a trust which owns a policy on the child's life. Proper drafting in this case requires that when the trust owns a policy on the beneficiary, such insured beneficiary not be able to exercise any authority over the trust or benefit in any way (e.g., access to cash values) from the policy.

A settlor may retain a power to substitute a new trustee without cause so long as the new trustee is not a related or subordinate party (as defined in §672), and of course, so long as the settlor cannot appoint himself or herself. Note that a similar power held by a trust beneficiary in a purely discretionary trust might be treated as a general power of appointment. A general power of appointment held by the beneficiary would cause the beneficiary to be treated as a grantor for GST tax purposes. To avoid this — and to preserve the original grantor as the grantor for GST tax purposes — some trusts limit a beneficiary’s trustee substitution power to exclude the beneficiary himself/herself (or a party related or subordinate to him/her).

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25 Treas. Reg §26.2632-1(c)
26 IRC § 2651(f)(3)
27 IRC § 2652(a)(3)
28 Rev. Rul. 95-58
**Corrective Provisions**

Some advisors recommend provisions allowing the trust to be split by the trustee or the trust protector for GST tax inclusion purposes.\(^{29}\) This may ease the procedure for cleaning up the trust if for some reason the GST tax exemption has not been properly allocated.

Alternatively, some commentators recommend authorizing the trust protector to grant the child a general power of appointment in order to allow the trust to be included in that child’s estate and therefore allow that child to allocate GST tax exemption to the trust.\(^{30}\) Inclusion in the estate can garner a step-up in basis for income tax purposes.

A limited power of appointment in a child will not affect the estate or GST tax elements, but will allow the child to make decisions about future distributions and allocations. This allows the child a mechanism with which to respond to changes in the law or circumstances. Where the trust does not have a perpetuities savings clause, such powers have to be exercised with care so as not to violate the perpetuities clauses of some jurisdictions.

Some states have “decanting” statutes that specifically authorize a trustee in certain circumstances to pour the assets of an irrevocable trust over to another trust. In short, these statutes permit the trustees to effectively amend the provisions of irrevocable trusts. For example, this might include changing the trust’s situs, electing in or out of grantor trust status, dividing or consolidating trusts, establishing separate shares, extending or accelerating the termination date, or correcting drafting errors. This ability to modify the trust might be helpful to address changing circumstances or changes in the tax law.

**Other Considerations**

As discussed earlier, one characteristic of a dynasty trust will be the duration of the trust for at least two generations and often for as long as state law allows. Some states have repealed the rule against perpetuities for personal property but not for real property. As a result, proper drafting requires that the situs be considered based not only on the maximum duration allowed by state law for such trusts, but also the duration based on the property with which the trust will be funded.\(^{31}\)

Creditor protection goals may be impaired if the beneficiary has the power to distribute trust property to himself or herself. Flexibility should be balanced against the probability of bankruptcy and other spendthrift concerns. Consider, for example, a beneficiary who can remove the trustee without cause. This may be considered sufficient control over the trust to prevent the beneficiary from qualifying for government benefits under Medicaid.

\(^{29}\) “Trust protector” is not a statutorily defined term. Usually it refers to a fourth party trust fiduciary – not the grantor, not a trustee, and not a beneficiary – who is the holder of one or more powers capable of affecting what the trustees are to do with the trust property. Restatement (Third) of Trusts, section 64, page 470. For example, a trust protector may have the power to add or remove beneficiaries, to terminate the trust, or to remove and replace trustees.

\(^{30}\) Drafters should be careful when using provisions that give powers of appointment to beneficiaries in GST tax trusts. While currently the GST exemption will shelter the trust from the GST tax as long as the property stays in trust, it is important to be mindful of §2041(a)(3) which section is commonly known as the Delaware tax trap.

\(^{31}\) For example, some jurisdictions may not allow - as against public policy - probated personal property to pass to a testamentary dynasty trust if the trust will violate the probate state’s rule against perpetuities, even if such a transfer would be allowed under the state law of the trust’s situs. A lifetime transfer of such personal property to a dynasty trust would avoid this limitation. See Cal. Prob. Code Section 21103. Also see, Restatement, Second of Trusts, Section 62, comment k (1959).
Grantors should consider creating a separate share (or distinct trust) for the children of a deceased child. They are not “skip people” for GST tax purposes, which in effect treats them as only one generation below the transferor for GST purposes.\footnote{IRC § 2651(e)(1)} As a result, transfers from such a separate trust for the benefit of these non-skip persons will not be subject to the GST tax even without the use of the grantor’s GST tax exemption.

Where the dynasty trust represents a small portion of the grantor’s legacy, the grantor might consider distribution provisions that more tightly limit access by the children’s generation. In this way, the trust’s value will more likely be preserved for the skip-persons. In such cases, the children could first access trusts that are not GST tax protected. In contrast, where the GST trust represents a large portion of the estate, the grantor may wish to give the trustee broad discretionary powers to distribute to the grantor’s children, since the children’s share will in large part derive from the assets of this trust.

6. Alternative Planning Options
Compared to traditional investments, life insurance with its ability to reduce or eliminate many of the above-mentioned risks has distinct advantages when used to fund a dynasty trust. Consider how the following issues relate to the funding of the trust without life insurance:

1. No Tax Deferred Growth Available
   Without life insurance, asset growth within a dynasty trust will generally not occur on a tax deferred basis. Income tax or capital gains tax will be due when assets are sold for a profit. This can hinder the growth of trust assets. It also increases market risk because paying income tax or capital gains tax can be an impediment to periodic portfolio rebalancing.

2. No Step Up In Basis At Death Available
   Assets given to a dynasty trust do not receive a step-up in basis to fair market value as they would if they had been taxed in the estate of each succeeding generation. While technically not a stepped up basis at death, life insurance death benefits are generally paid income tax free.\footnote{For federal income tax purposes, life insurance death benefits are generally received income tax-free by the beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).}

3. No Initial GST Financial Leverage Available
   Without life insurance, there will be no immediate increase in the amount of wealth transferred at the death of the insured. In other words, the value of the trust assets will be their fair market value for gift tax purposes. This value will only increase over time with market appreciation and income accumulation.

In dynasty trust planning, the focus on long-term low risk wealth accumulation/preservation lends itself to life insurance because of the combined effect of (a) the leverage associated with

\footnote{32 IRC § 2651(e)(1)}
the insurance structure of premiums/death benefit (i.e., cost of premiums can be much lower than the death benefit), and (b) the market and mortality risk reducing elements represented by the insurance product’s contractual guarantees.  

Life insurance is not without its drawbacks, of course. A trustee must consider, for example the liquidity needs imposed by the trust’s anticipated distribution requirements. Of particular concern in this context are the surrender charges applicable to many insurance policies in their early years. A trustee very often will not be able to surrender a policy for the even the amount of premium paid until the policy has been in force for several years. Where a trust beneficiary has immediate or near-future distribution rights, the trustee should ensure the trust owns sufficient liquid assets to match the rights of the beneficiary. The timing of the death benefit also enters into the equation. A trustee should carefully consider how the longevity of the insured will affect the trust’s ability to make future distributions. For example, a trust that requires regular cash distributions as a beneficiary reaches target ages should be careful to reserve enough cash (or other relatively liquid assets such as CDs or laddered bonds) to make the distributions. A life insurance policy death benefit will not be available for such interim distributions until the insured dies. Even where the policy has cash value, the trustee should evaluate how much cash will be available through withdrawals and loans from policy and how much should be invested in other assets. 

When life insurance is used as a funding mechanism for a dynasty trust, the grantor’s GST tax exemption need only be allocated against the premium gifts – and not on the amount of the death proceeds ultimately received. This leverage allows the grantor to conserve the amount of GST tax exemption that must be used to exempt the life insurance and therefore, it permits more of the grantor’s other property to be sheltered from the GST tax by using the remaining exemption available (either during life by making gifts or at death by making bequests). In the case of a properly formed trust that only owns life insurance, once the premiums given to the dynasty trust are GST tax exempt, then the entire death proceeds and policy cash values derived from the payment of those premiums are also GST tax exempt. Thus, dynasty trusts funded with life insurance should be structured such that they have an inclusion ratio of zero. 

Additional leverage might be achieved by using second to die life insurance as the funding mechanism rather than individual life insurance. Generally speaking, the premium per $1,000 of death proceeds for second to die coverage is much less than the premium per $1,000 of death proceeds for individual life coverage. This is the case because second-to-die coverage insures two lives and pays a death benefit only after both insured parties die. Depending on the financial goals of the client, it may be that second to die coverage could achieve the client’s objectives more efficiently than individual life insurance. For example, if the financial goal of two grandparents is to have $5,000,000 of cash in their dynasty trust after they die to benefit their children, grandchildren and great-grandchildren, then second to die coverage could achieve this objective at a much lower cost per $1,000 of death benefit than by using individual life insurance on the life of only one of the grandparents. Of course, with second to die, annual premiums

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34 Guarantees are based on the claims-paying ability of the issuing insurance company.
35 Distributions from a life insurance policy through withdrawals of certain policy values (up to cost basis) and loans are generally not taxed as income provided certain premium limits are followed which prevent a policy from becoming a modified endowment contract (MEC). Distributions taken during the first fifteen years may be subject to tax. Loans and withdrawals will generally reduce the cash value available and death benefit payable. If policy loans are taken, there may be income tax consequences if one permits the policy to lapse or if the policy is surrendered or exchanged.
might have to be paid over the lives of both grandparents and the proceeds would not be received until the time of the second death.

A good example of an estate planning goal that might be achieved by having second to die insurance owned by a dynasty trust is to create the necessary liquidity to pay estate taxes at the second to die of two grandparents. In such a case, the death proceeds could be used to purchase assets from the estate of the grandparent who died second so that the estate would have the liquidity needed to pay the taxes due but the trustee of the dynasty trust would be able to manage the assets purchased from the estate for the benefit of the children, grandchildren and great-grandchildren.

**Example:** Grandmother and grandfather create a dynasty trust for children, grandchildren and great-grandchildren, subject to the applicable rule against perpetuities. They transfer $4 million to it. Each grandparent allocates $2 million of his or her $5 million exemption to it. The trustee is authorized to sprinkle income and principal to the children, grandchildren and great-grandchildren. Using some of the trust’s $4 million, the trustee purchases a survivorship life policy with a $20 million death benefit. The death benefit is used to provide liquidity to the estate of the surviving insured by buying assets from the estate. The $20 million of property and cash is now available to sprinkle income and principal to the named beneficiaries.

Even more leverage might be achieved when second to die coverage is owned by a dynasty trust and premiums are paid under a private split-dollar arrangement. Using private split dollar, while both insureds are living, the annual allocation of the grantor’s GST tax exemption is equal to the revised Table 38 cost. Since this economic benefit cost is based upon the assumption that both insureds would need to die in any one particular year, this amount is generally small, as compared to the annual premium, even at older ages.

Private split dollar has risks and limitations, of course. In the case of second to die policies, the economic benefit cost increases dramatically upon the death of one of the insureds. Even prior to the first death, the economic benefit amount will begin to exceed the premium, resulting in gifts larger than would have been the case if split dollar had not been used. When considering use of a private split dollar arrangement, it is important to devise a viable exit strategy prior to entering into the arrangement.

The primary benefit of the private split-dollar arrangement is to minimize the value of the gifts made in order to purchase the insurance policy in trust. While all of the cash values are assigned to the insured grantors, neither insured can have the right to access the cash values. If they have the right to borrow or withdraw the cash value, this ability would be considered an incident of ownership and would result in the inclusion of the policy death proceeds in the insured’s estate.

36 Under one common form of private split dollar, the dynasty trust owns a second to die policy. The insured grantors gift the economic benefit cost to the trust and the trust pays that portion of the premium to the insurance company. The balance of the premium is paid directly by the insured / grantors, but it is not considered a gift to the trust. It is for tax purposes an advance secured by policy cash values and which the insured / grantors will be repaid (possibly not until death). A full discussion of private split dollar is beyond the scope of this article. However, more information can be found in issue of Legal & Tax Trends titled “Private or Family Split Dollar”.
7. Conclusion
While certainly complex, a properly drafted, funded, and operated dynasty trust can be a powerful tool for achieving a client’s financial objectives. It can effect legacy goals that reach not only to a person's children and grandchildren, but also to succeeding waves of future descendants for as long as the trust has assets and the law allows. It cannot only remove the trust assets from the grantor’s estate like a common irrevocable trust but in addition, it can enforce the grantor’s distribution and legacy goals beyond the normal trust’s life span.
**Legal & Tax Trends** is provided to you by a coordinated effort among the Advanced Markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele B. Collins, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. All comments or suggestions should be directed to Tom Barrett, tbarrett@metlife.com or John Donlon, jdonlon@metlife.com.

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