Dynasty Trust: Passing Wealth Down the Generations

Many families would like to pass their wealth down to their children. In turn, their hope is that their children will be successful and can pass wealth down to the next generation, and so on. Unfortunately, along the way, each transfer between generations gives the federal and state tax authorities the opportunity to levy and collect estate and gift taxes, thus diminishing what is actually left for the next generation. How can you maximize your family's financial legacy?

One Solution: Create a Dynasty Trust

Many of the country's wealthiest families often use trusts as a method for transferring wealth. One trust that they use to transfer wealth between multiple generations is called a "Dynasty Trust." These trusts enable affluent families to benefit multiple generations with a single transfer of property, and to make distributions to descendants for their needs.

Background

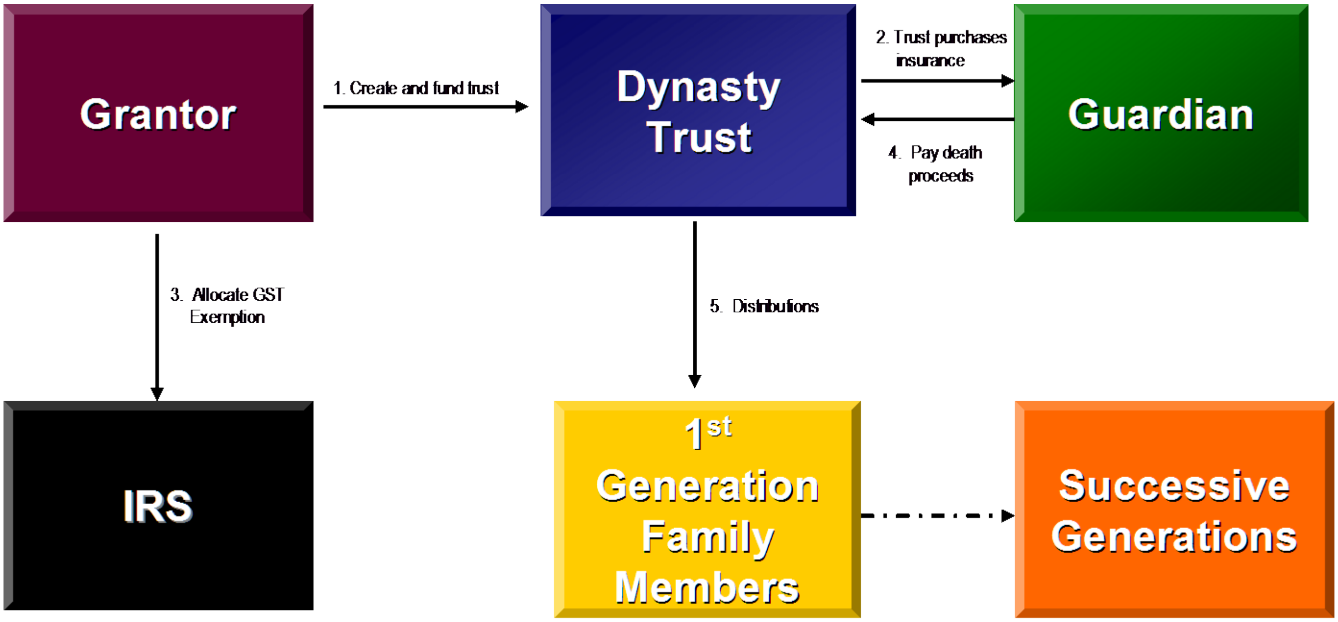
At one time in our history, there was no limit to the amount of property that could be left in trust for the benefit of multiple generations of family members. Ultra-affluent families used trusts to avoid the transfer taxes that would otherwise apply when property was transferred down through successive generations. Many of the great family fortunes were passed down intact, over long periods of time, in this manner. However, being too much of a good thing and with substantial tax revenue being lost, in 1986, Congress created the "Generation-Skipping Transfer Tax" (GST tax). The GST tax greatly reduced the ability to pass unlimited wealth to successive generations without tax consequences.

The GST tax was designed to protect against the avoidance of gift and estate taxes when property was transferred, either outright or in trust, during life or at death, to individuals more than one generation below that of the transferor (e.g., grandparent gifting directly to grandchild, bypassing the child). The GST tax is complicated in its application and expensive when assessed – currently at a 40% tax rate, although current laws provide an exemption from the GST tax of $10 million per person (indexed annually for inflation). Careful planning must be made to assure that transfers fall within the exemption. Dynasty trusts are designed to take advantage of this exemption.

Dynasty trusts are even more efficient and impactful when they are funded with highly appreciating assets or life insurance. Since, however, it is difficult to predict if assets will continue to appreciate over a long period of time, life insurance is often a better funding vehicle. The reason for this is the leverage that a life insurance death benefit has relative to the premiums that need to be paid. The death benefit is often a significant multiple over the total premiums paid, but it is the premiums paid that would count towards the GST tax exemption.

The other complicating factor to the use of Dynasty Trusts is that historically states have had laws that limited the lifespan of trusts. These laws were called the "Rule Against Perpetuities" and they effectively limited trusts to a term of 90-120 years, after which the trust would have to terminate and distribute the balance of principal and income to the remaining beneficiaries. More recently, however, starting in the late 1990's, many states began to repeal their respective Rule Against Perpetuities, so that it is now accurate to say that a trust can be a true "perpetual" or "dynasty" trust. Over 25 states have abolished or significantly modified their version of the Rule Against Perpetuities. The list continues to grow.

How Does it Work?



1. Joe has expressed an interest is establishing a trust that would allow him to benefit his family for multiple generations. With the assistance of Joe's estate planning attorney, a multi-generational Dynasty Trust is created and he gifts money each year to the trust, in an amount that would cover the life insurance that the trust intends to purchase. The attorney instructs Joe on some of the technical requirements in making the gift to ensure that Joe leverages his GST exemption.
2. The trustee of the Dynasty Trust purchases and owns the life insurance on Joe's life and makes the premium payments.
3. Joe, with the help of his tax advisor, notifies the IRS that he has used some of his GST tax exemption to shield the Dynasty Trust from the GST tax.
4. Upon Joe's death, the insurance proceeds will be paid to the Dynasty Trust.
5. The trust assets can continue to be held in trust for the benefit of multiple generations of Joe's family. The assets continue to grow but the trustee has the ability to make distributions to family members as the trust's beneficiaries. This can continue in perpetuity.

In the above example, the Dynasty trust is created during Joe's lifetime and funded with cash to allow the trust to purchase life insurance on Joe's life. Joe's wife could have joined him in this arrangement and the trustee could have purchased survivorship life insurance on their joint lives. Joe could also have gifted other assets, such as securities, that he believes will continue to grow in value. In addition, Joe could have opted to have this trust created at his death, funded with assets held in his estate.

Dynasty trusts can benefit all sorts of families, not just the wealthy, particularly if their goals include:

- A desire to provide for multiple generations of family members
- An interest in protecting accumulated assets from estate and generation skipping transfer taxes
- A concern about protecting accumulated wealth from creditors and ex-spouses
- A desire to ensure the transfer of family values to successive generations in the form of incentive provisions

By creating a Dynasty trust, families can leverage the available GST tax exemption to shield trust assets from the GST tax; maximize wealth for future generations by leveraging life insurance; and shield assets from tax, which allows the value of trust assets to grow even greater than would have been possible, had those assets passed directly from generation to generation.

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PUB8080 (12/16)
2016-32306

Expiration: 12/31/2018

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