

One of the most distressing facts about death taxes for wealthy clients is that each time property passes from one generation to the next, the IRS collects over 45% in death taxes. For example, assume an 80-year-old in the 48% bracket leaves \$1 million to his child age 58. The child is left with \$520,000 after taxes, which in turn may be taxed again at 45% when the child dies 15 years later at age 73, leaving only \$286,000 of the original \$1 million for grandchildren.

Previously, it was possible for wealthy clients to avoid federal estate taxes in their descendants' estates by creating a trust that provided for successive income interests in each generation. Generally, there is no federal estate tax imposed on property when the decedent has only a lifetime income interest. However, Congress closed this loophole by enacting a tax on generation-skipping transfers (GST) at the highest estate tax rate on transfers to beneficiaries who are more than one generation younger than the person making the t

ransfer (for example, a grandparent to a grandchild). The GST tax is in addition to the regular federal gift and estate tax. However, a person may transfer up to \$1.5 million (2004) (indexed for inflation) to younger generations without the imposition of the GST tax (\$3 million for a married couple). This is known as the "GST exemption."

A dynasty trust offers a remarkable transfer tax shelter for your descendants by funding the trust with all or part of your GST exemption. A dynasty trust is an irrevocable trust created during your life or at your death in your Will which provides distributions of income to children or adds undistributed income to principal. The Trustee usually is given the flexibility to distribute principal for the health, education, maintenance and support of the beneficiaries. Upon the children's deaths, the income and principal becomes available to the grandchildren for their lifetimes, and so on, down through successive generations of the family. A \$1 million gift or bequest to a "dynasty trust" can grow to a phenomenal amount when the trust ends 100 or more years later, particularly when the amount is not reduced by successive death taxes. For example, if \$1 million were invested by the Trustee in common stocks, which appreciated in value at the same rate stocks have appreciated over the last 100 years, the original trust corpus of \$1 million would grow to over \$200 million in 100 years. In addition, the trust can protect the heirs from themselves, spouses and their creditors through a spendthrift provision.

The dynasty trust can be significantly leveraged by purchasing single life or second-to-die life insurance. The GST exemption applies to the amount of your contribution to the trust, not the value of the trust assets. Assume you are a standard risk, age 50 or 60, and you contribute \$1 million to a dynasty trust which in turn purchases \$4 - \$6 million of life insurance on your life. If your spouse joins in with another \$1 million contribution, the policy proceeds (trust principal) could be worth double this amount at your death. The funding of a life insurance dynasty trust could be further leveraged through the use of a split-dollar arrangement whereby all or a portion of the premium is paid by your closely-held business. The Trustee could be authorized to use trust assets to purchase life insurance on the lives of one or more beneficiaries, thereby providing additional leverage or offsetting any distributions from the trust to beneficiaries for their needs.

Most state trust laws limit how long a trust can last (typically 80-110 years), which restricts the use of a "perpetual" dynasty trust. A few states, such as Alaska, Delaware, Idaho, Illinois, South Dakota and Wisconsin, have no time limits, making it attractive to create the trust in such states. However, these states may require that at least one Trustee be a resident of the state and most estate planners recommend that some or all of the trust assets be physically located in the state and as much administrative activity as

possible should take place in such state in order to insure such state's trust laws will apply.

Louisiana trust law imposes a time limit on trusts. Normally, a Louisiana trust terminates at the death of the last beneficiary. A trust can be created for a "class" of beneficiaries, such as children, grandchildren, and great-grandchildren, who would be automatically added as beneficiaries of the trust upon birth or adoption after the creation of the trust, provided that at least one of the beneficiaries of the class was in being at the time the trust was created. Thus, the class could be defined as all children, grandchildren, and great-grandchildren, and provided you had at least one child alive when you created the trust, the trust would not terminate until your last great-grandchild dies. Therefore, you do not have to go to Alaska, Delaware or South Dakota to set up a dynasty trust.

Although Louisiana appears to permit the creation of limited dynasty trusts, there are some state income tax implications which should be considered. A Louisiana income beneficiary of the trust will be subject to Louisiana income taxes on income distributions from the trust. Undistributed income and income distributed to a nonresident beneficiary, however, will be subject to trust state income tax. South Dakota, on the other hand, has no trust state income tax. This may not be a material issue in choosing which state to establish the trust since the federal income tax on undistributed trust income in excess of \$7,500 is taxed at 35%, thus discouraging accumulation of income in a trust.

The dynasty trust offers significant long-term flexibility to clients who want to establish a tax-favored source of income and capital to future generations of family members without erosion from further successive taxes. The dynasty trust can be combined with the features of an incentive trust.

For more information please view the publication: [Incentive Trusts](#).

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