Dynasty Trust

A Dynasty Trust permits wealth to be passed to multiple generations without transfer taxes being imposed on assets at each generation level, even though the trust beneficiaries may have use of the trust assets that can be in effect equal to outright ownership. (Dynasty Trusts are also sometimes referred to as Generational Trusts or Perpetuities Trusts.) Usually, an individual who sets up a Dynasty Trust elects to allocate a sufficient amount of his or her generation-skipping transfer tax ("GST") exemption against the transfer so that the trust is fully exempt from GST taxes.

Duration of Dynasty Trust

Under the law of some states, a Dynasty Trust may last "forever." A nonresident of such a state may establish a Dynasty Trust that is governed by that state's law, if the trust is carefully and properly drafted. In Utah, a trust can only last as long as the "Rule Against Perpetuities" permits—currently 1,000 years.

Dynasty Trust Affords Creditor Protection

Some states have passed legislation that may give a Dynasty Trust additional protection against creditors' claims against the Settlor of the trust. However, the effectiveness of creditor protection against the Settlor is unclear. Even if the trust cannot be used to protect against the Settlor's creditors, it may be used to protect against the creditors of a beneficiary and to prevent the dissipation of the assets during the beneficiary's life. Dynasty Trusts may possibly also protect against claims of a beneficiary's spouse in the event of a divorce.

Providing for Beneficiaries

While a Dynasty Trust would be managed to avoid the imposition of transfer taxes at each generational level, this purpose must be balanced with the objective of providing for the trust beneficiaries. In making distributions from the Dynasty Trust, the trustee may take into account transfer tax considerations before making any distribution and can be encouraged to provide for the "use" of the trust assets rather than making outright distributions. For example, instead of making a distribution to a beneficiary to enable him or her to purchase a home, the trustee could purchase the home in the name of the trust, keeping it as a trust asset and sheltering the appreciation within the trust, while permitting the beneficiary to reside in the house and use it as his or her principal place of residence. The trust may encourage beneficiaries to pay for their own consumable assets and the trustee to purchase assets that may appreciate for future generations.

Distributions Based on Clients' Values and Beneficiaries' Accomplishments

Saving transfer taxes is not the only goal of Dynasty Trusts. Often clients desire to create trusts in a way that encourages their descendants to be productive members of society. Since it is impossible to predict the needs of the future beneficiaries when a Dynasty Trust is created, the trust provisions must be flexible. This can be accomplished by giving beneficiaries limited powers of appointment. Another way to provide for the future needs of the beneficiaries while ensuring that the future beneficiaries will not live off of their inherited wealth is to base distributions on accomplishments or incentives.

Incentive Distributions. An example of an incentive provision is allowing a beneficiary to receive a distribution only upon college graduation or only for starting a business. Such incentive distribution provisions can be used to encourage goals related to the preservation of a Settlor's personal and family values and ethics.

Any incentive provision should be realistic and clearly understandable by both the beneficiaries and the trustees. Some clients may wish to authorize or direct distributions that are meant to "match" in some proportion the earnings of beneficiaries from employment, business, or investments. Other clients may wish to compensate beneficiaries who pursue careers or other activities that are consistent with a Settlor's sense of public or family duties or religious or aesthetic values. Properly drawn incentive provisions can encourage beneficiaries to pursue professions or activities that are consistent with the Settlor's personal sense of what constitutes "success" but that would not necessarily result in financial reward.

Safety Net. The trust may also be structured to provide a safety net for the beneficiaries if they are ever in need of assistance, i.e., due to the loss of a job or the need for long-term care. However, the trust should be designed to supplement the beneficiary's income or benefits, and should not become the beneficiary's sole source of income. Heavy reliance on the discretion of the trustee may be necessary to keep the trust flexible through successive generations.

Trustee. The choice of a trustee is crucial, particularly if the distributions rely on the discretion of the trustee. Many clients want their children and then their descendants to act as the trustees of any trusts they create. However, the tax consequences to a beneficiary who is also a trustee must be taken into account. It may be necessary to appoint an independent co-trustee or permit discretionary distributions within an ascertainable standard (e.g., health, maintenance, and support).

Due to the perpetual nature of the Dynasty Trust, the line of trustee succession will be far removed from the initial trustees known to and chosen by the Settlor. It may be appropriate to consider appointing a corporate fiduciary to serve if named individual trustees are no longer available to serve. This could be done in conjunction with a safeguard that allows beneficiaries to substitute a different corporate trustee in appropriate circumstances. Alternatively, the trustee provision may contemplate that there will be one or more family members appointed to serve as co-trustee together with a corporate trustee or another "independent" trustee (for both substantive and tax reasons) for determinations as to discretionary distributions.

Careful consideration also needs to be given to the investment options allowed by the trustees so that the income generated by the trust reflects the goals of the client. If a Dynasty Trust is intended to last forever, sufficient income must be produced to satisfy the potential distributions while invasions of principal need to be limited to allow the assets to grow. If the goal of the Dynasty Trust is to distribute the family wealth to deserving descendants, invasions of principal should be expected. The Dynasty Trust can act as a family "bank" from which loans may be obtained for businesses or other such assets that will assist the beneficiary in becoming a productive member of society. If asset protection is also a goal of the

trust, the trustee may be given the power to purchase assets (e.g., businesses) for the beneficiaries to operate within the trust, thereby allowing the assets to remain in an environment that is protected from creditors and marital settlements.

One of the disadvantages of an incentive-oriented distribution scheme is the family disharmony that may be caused by the inequity of the distributions among the future beneficiaries. A narrowly drafted provision, such as one giving each descendant a certain sum of money upon graduation from college, favors the college graduate regardless of the accomplishments of the beneficiary who becomes productive without a college degree. In general, incentive provisions and related terms of a Dynasty Trust should be drafted broadly enough so that the "rewards" are not so restrictive as to preclude benefiting those who achieve success in nontraditional ways.

The Settlor may provide general guidelines for the incentives but allow the trustee to take into consideration other facts and circumstances in order to demonstrate that the client's family values and work ethic have been met. At times, it may be appropriate to add a detailed expression of the Settlor's philosophy regarding effort and success. Although this would not be a legally binding direction, it would act as a guide to the trustee in future circumstances that cannot be foreseen by the Settlor.

Directed trusts are increasingly common ways to administer trusts. A directed trust has a trustee, usually a corporate trustee, and then has a "direction advisor" (sometimes known as in investment advisor). This direction advisor is empowered under the terms of the trust to make certain decisions that a trustee would usually make. Often the direction advisor is the one to make investment decisions. In other cases, the direction advisor could also have the power to direct distributions to beneficiaries.

One advantage of having a directed trust would be the ability to direct the trustee to retain a concentrated positioned stock. Without directed trust provisions, most trustees would not be comfortable retaining concentrated positions of stock.

How do we make a trust a directed trust? Almost all existing trusts are not directed trusts since they are fairly new arrangements. Many states that have favorable laws for long-running trusts such as Utah, Delaware and South Dakota allow for directed trusts.

Who will serve as the direction advisor? It appears that the direction advisor may have fiduciary duties so it is important to choose someone who will be comfortable in that role. It is also important to choose someone who will not negatively impact the estate or income tax treatment of the trust.

The Dynasty Trust is a useful tool that can help accomplish the goals of clients in estate planning today. Careful consideration needs to be given to the tax and nontax consequences to the Settlors as well as to the beneficiaries. With proper drafting, a Dynasty Trust can be a flexible tool able to survive through successive generations.

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