© 2013, All Rights Reserved

LEFKOFF, DUNCAN, GRIMES, MCSWAIN & HASS, P.C.

Multi-Generation Transfers and Dynasty Trusts

Unmarried Taxpayers

The Most Powerful Force in the Universe is Compound Interest.

attributed to Albert Einstein

Multi-generation planning offers important non-tax benefits which may represent important goals for many people whether or not there is an estate tax component to the planning. In those estates which are larger than the available estate tax exemptions ($5.25 million in 2013), such planning can also greatly reduce the tax liability in future generations and increase the family's ability to preserve the wealth in an inflationary environment.

Estate Planning professionals have long recognized that, with larger estates, it is much easier to hold the estate together for the family if it is exposed to taxation only once every two or three generations, rather than at every generational level. In order to place some limitation on this tax avoidance planning, Congress enacted the generation skipping transfer tax ("GST Tax"). In effect, the GST Tax is a "substitute" for the estate tax, and imposes a tax at the generational level which would not otherwise be subject to estate taxation. While the tax itself can be quite large, equal to the maximum estate tax rate in effect at that time, there are also large exemptions available. Most tax planning in this area, then, focuses on maximizing the use of the exemptions, and even "leveraging" them to create much larger generation skipping transfers free of any tax.

In brief, two exemptions from the GST Tax are available:

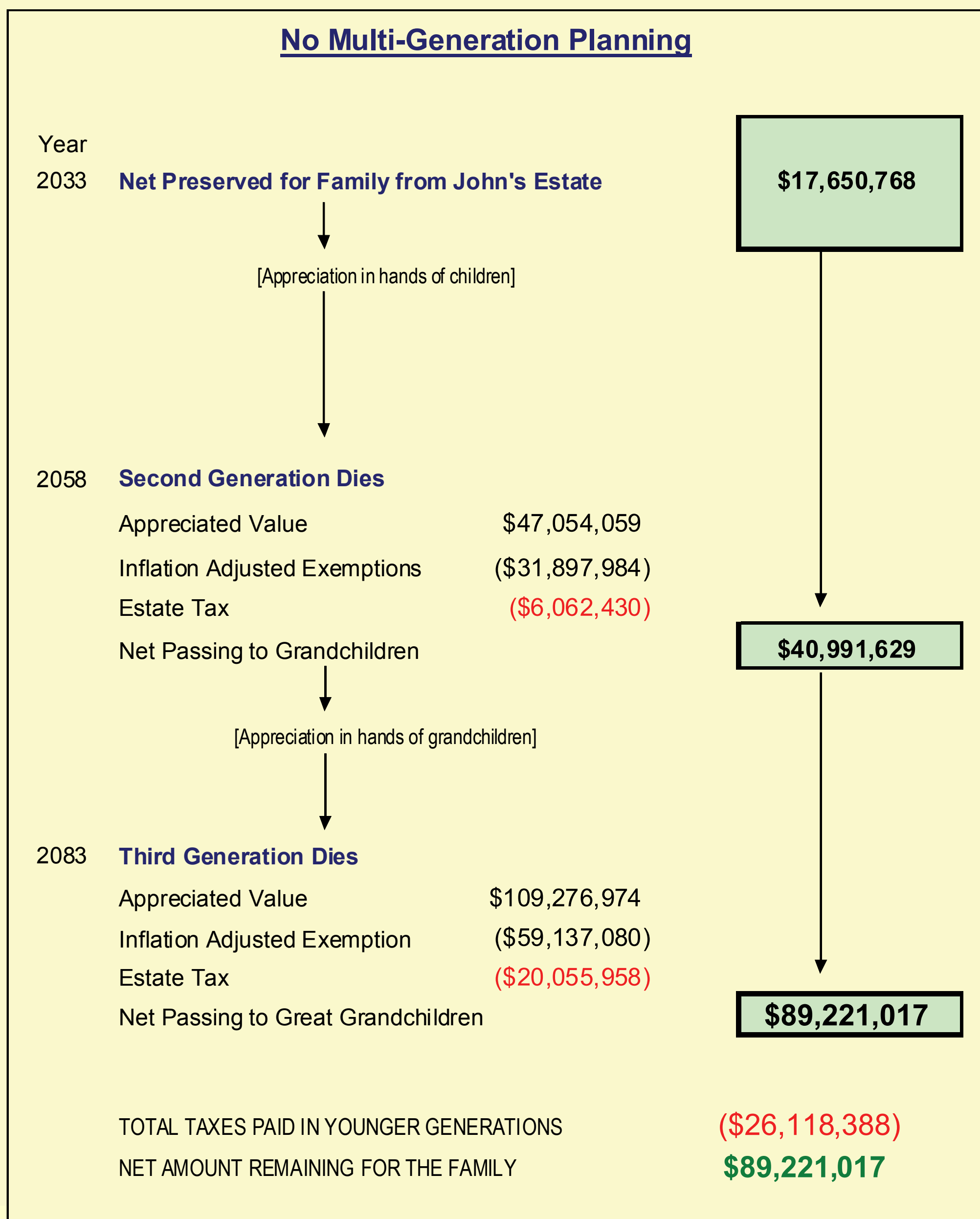
The GST Exemption. Every transferor has a blanket exemption applicable to all transfers during life or at death. It may be allocated to various transfers as one wishes. Following the 2010 Tax Act, the amount of this exemption is fixed at $5,000,000 plus an annual inflation adjustment. For 2013, the adjusted GST Exemption amount is $5,250,000.

The Annual Exclusion Exemption. Any gifts which are exempt from gift tax under the $14,000 annual gift tax exclusion are also exempt from the GSTT, so long as the gift meets certain "vesting" requirements.

These exemptions are allocated by the taxpayer to gifts made during his or her lifetime, either by filing a gift tax return and claiming the exemption on that form, or by electing to have the exemption automatically applied to all transfers to a particular trust. The exemption applicable to transfers taking effect at death (under a Will or Living Trust, for instance) may be automatically allocated to certain trusts and is otherwise allocated by the taxpayer's executor when the estate tax

return is filed. The proper allocation of the exemptions is crucial to effective planning in this area, and care must be taken to ensure that the estate distribution is structured to facilitate the maximum use of the exemptions.

In larger estates, the proper use of the GST Exemption to protect family wealth from taxation through successive generations can easily have a dramatic effect on the amount of the family's wealth which can be preserved. Consider, for example, the following illustration showing John Doe's estate leaving $17,650,768 for the children (after all estate taxes,) with the expectation that the children will leave it to their two children. This illustration assumes that the estate grows at a net rate of 4% annually, and that each generation passes it along in 25 year intervals subject to normal estate taxation (assuming total available exemptions adjusted for inflation at 3% per annum in each generation.)

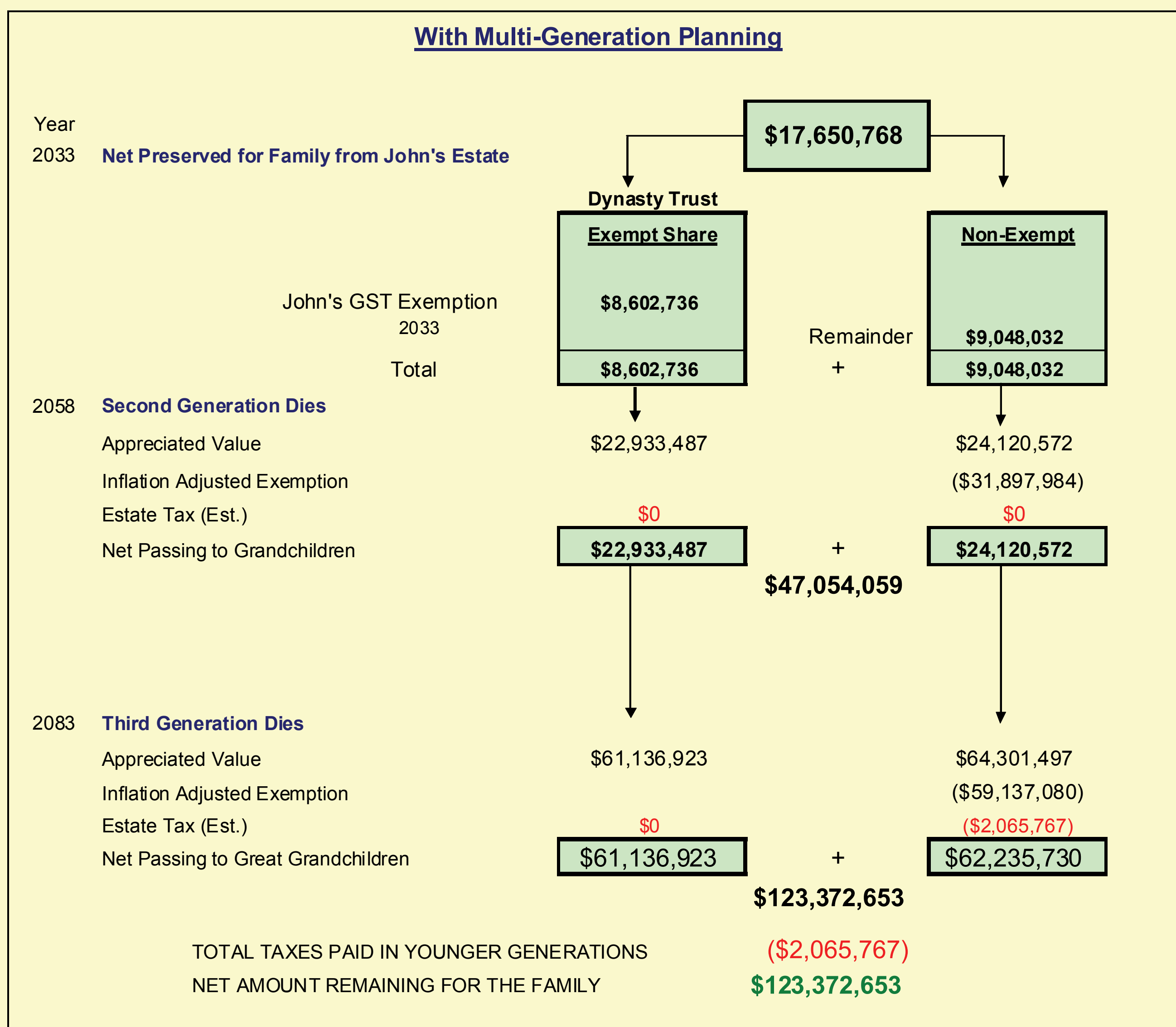


© 2013, Lefkoff, Duncan, Grimes, McSwain & Hass, PC

If the real inflation rate over the years is 2.5% annually, then the family has lost about ⅓ of its 4% annual investment appreciation as a result of the estate tax, and has absorbed about $26.1 million in extra tax cost in two generations.

In addition, the family's wealth has been unnecessarily exposed to the risks of loss through marital problems and creditor challenges arising in the children's and grandchildren's generations.

Alternatively, if John had left the same estate with the Family Trust designed as a "dynasty trust" for his descendants, and with his will designed to leave the maximum GST exempt amount protected in that trust, then at the end of the same 50 year period the wealth would have grown to $123,372,653.



© 2013, Lefkoff, Duncan, Grimes, McSwain & Hass, PC

If we again assume that the real inflation rate over the years is 2.5% annually, then the family has now gained about 106% above the real inflation-adjusted value of its wealth in two generations and borne a much smaller estate tax cost.

Perhaps more importantly, the family's wealth has been much better protected from loss as a result of marital discord and business or financial challenges in the younger generations. In most states, the continuation of the trust prevents the property from becoming "marital property" to be divided between spouses in a divorce settlement. The trust can also shield the property from claims of a beneficiary's creditors - even in Bankruptcy. Some states' laws provide much greater protection in this area than do others. It may be important, therefore, to consider where such a trust should be created for the family and whether a mechanism should be included to "move" the trust to another legal home if appropriate at some later time.

In a dynasty trust, legal (taxable) ownership of the trust property is not distributed outright to the children or grandchildren. Instead, the trust may simply provide (liberally, if preferred) for the use of each child's share of the trust assets for the child and the child's descendants. The trust may, for instance, be authorized to expend its income and/or principal for the support, maintenance, and education of the family members. It may be authorized to invest in the family's business ventures, and to purchase and hold property (such as vacation homes) for the use of the family. Such a trust can enable the family to use the family wealth in much the same way one may contemplate it would be used if it were left outright to the beneficiaries. Upon the death of a child for whom a share of the trust is held, the deceased child can be empowered to direct the manner in which the trust property will continue for his or her own children, just as the child would be able to do in his or her Will if the property were owned outright.

The trust is controlled by the trustee or trustees. If one wishes, control can be given to the child for whom the trust is created simply by naming that child as the trustee. The child, as trustee for himself and his family, would have essentially the same scope of economic control as if the property had been distributed outright. Alternatively, multiple trustees can be named, and/or a professional trustee may be employed to manage the trust. Provisions for resignation, removal, and replacement of trustees can be included, and "committees" and "trust protectors" may be created to control certain types of decisions much as a board of directors might oversee the management of a business enterprise.

Dynasty trusts, then, provide an opportunity to protect the family's wealth not only from the long term effect of estate taxation where that is important, but also from much of the risk of financial loss from business failures, marital discord, and other legal difficulties. Their creation requires careful planning, integration with the effects of the estate tax and generation skipping transfer tax system, and consideration of the trust administration and management issues which arise in a trust which may well last for several generations.

Legal Opinion Disclaimer

and

IRS Circular 230 Notice:

The information provided herein is intended for general understanding only, is not a legal opinion on which anyone is authorized to rely for any purpose, and should not be applied to any individual's unique circumstances except through representation of competent legal counsel. Nothing herein is intended to establish an attorney-client relationship between Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. and the reader or any other person.

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.