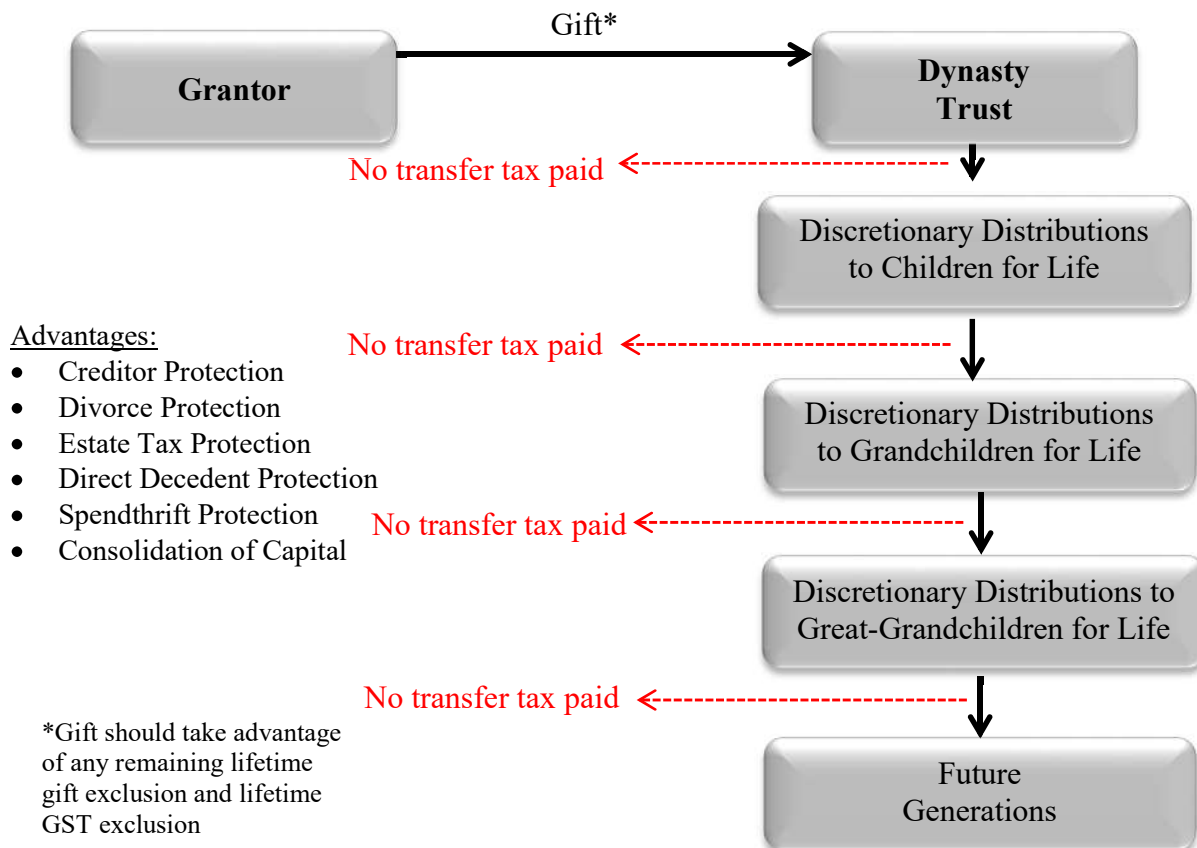


## #22: Dynasty Trust

Historically, taxpayers paid gift or estate tax only once on a wealth transfer regardless of how many generations the transferee was below the generation of the transferor. For example, the tax on a transfer to a great grandchild was the same as the tax on a transfer to a child. Moreover, taxpayers could drop assets down multiple generations by creating a trust with successive life estates.

In an attempt to block this strategy, Congress enacted the generation-skipping transfer tax (GSTT). The GSTT does not apply a tax each time property drops down a generation, but simply adds a second layer of tax to transfers that skip one or more generations, regardless of how many generations they skip. Thus, the tax on a transfer to a grandchild is taxed the same as a transfer to a great grandchild or a transfer to a trust that skips multiple generations. In all cases, there is one level of gift or estate tax and one level of GSTT.

A dynasty trust takes advantage of how the GSTT is applied by passing assets down through successive generations of a family for as long as the trust is permitted to last under applicable state law. A taxpayer uses the gift and GSTT exclusion amount to avoid tax on the initial transfer to the trust. No transfer tax is payable at any generation of beneficiaries thereafter because the beneficiaries have only discretionary interests that are not includable in their estates when they die. Thus, in some states, a one-time use of the gift and GSTT exemption eliminates transfer tax for a family forever.



Future trustees can be given absolute discretion to make distributions they deem appropriate or the grantor can provide guidelines for distributions, providing a measure of control long into the future. For example, the grantor might establish distribution standards designed to positively affect future behavior. The following example illustrates how a dynasty trust works.

**Example 1.** In 2024, F transfers \$10,000,000 to a dynasty trust for the benefit of her son S for life, upon S’s death to S’s daughter GS, then to GS’s children and so on down through the generations of F’s family in perpetuity. F pays no tax when the trust is created because the gift tax is eliminated by the \$13,610,000 gift tax exemption in effect for 2024 and the GSTT is eliminated by the \$13,610,000 GSTT exemption. Moreover, no tax is paid when F dies, when S dies, when GS dies or when any other beneficiary dies. No federal transfer tax will be paid even when the trust terminates and the trust property is distributed to the last beneficiaries.

The following examples illustrate the power of dynasty trusts over a long period of time.

**Example 2.** F transfers \$10 million to a testamentary dynasty trust for the benefit of his heirs. Assume that all trust income is transferred to trust beneficiaries and none is accumulated. The chart below compares the family’s wealth at the end of each generation if a dynasty trust is used with the family’s wealth if the family does no planning and each generation transfers the assets at death. The chart assumes that a 40% estate tax rate applies throughout the time period.<sup>72</sup>

Generation	Dynasty Trust	No Dynasty Trust	% of Initial Balance
One	\$10,000,000	\$10,000,000	100%
Two	\$10,000,000	\$6,000,000	60.0%
Three	\$10,000,000	\$3,600,000	36.0%
Four	\$10,000,000	\$2,160,000	21.6%
Five	\$10,000,000	\$1,296,000	12.96%

Note that the amount of wealth left at the end of a given generation is simply  $A * 0.6^{n-1}$ , where “A” is the initial amount used to fund the trust, 0.6 is 1 minus the estate tax rate of 40%, and “n” is the number of generations. Thus, for example, the amount left at the end of Generation 6 is  $\$10,000,000 * 0.6^{5-1} = \$10,000,000 * 0.6 * 0.6 * 0.6 * 0.6 = \$1,296,000$ .

**Example 3.** Assume the same facts as in Example 2 except that the dynasty trust makes no distributions, instead accumulating value for future generations. Assume further that the trust assets grow at seven percent after tax and that the generations of the family are 30 years apart. The following chart shows the wealth accumulation of the dynasty trust.

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<sup>72</sup> The chart also assumes that at each generation, the decedents have sufficient other assets (to use up their lifetime gift exclusion amount) so that assets passed down from the original \$10,000,000 are fully subject to a 40% estate tax rate.

<b>Generation</b>	<b>Dynasty Trust Value</b>
One	\$10,000,000
Two	\$76,122,550
Three	\$579,464,268
Four	\$4,411,029,799
Five	\$33,577,877,560

Of course, inflation and the time value of money would have to be taken into account to make a fair comparison. For example, if we apply a 4% inflation adjustment to the \$4,411,029,799 amount in the trust at the end of the 4<sup>th</sup> generation (90 years after F dies), the amount is reduced to \$129,282,415. This is still an excellent result considering that we are using constant value dollars.

Perhaps a more likely fact pattern is one in which some of the trust income is distributed and the balance is left to accumulate in the trust. Consider this final example.

**Example 4.** Assume the same facts as in Example 2 except that the trustees do not distribute all of the trust income, leaving enough in the trust to provide a 2% growth rate. The growth of the trust assets is shown below.

<b>Generation</b>	<b>Dynasty Trust Value</b>
One	\$10,000,000
Two	\$18,113,616
Three	\$32,810,308
Four	\$59,431,331
Five	\$107,651,630

In addition to the impressive transfer tax benefits, dynasty trusts can also provide creditor protection, divorce protection, and spendthrift protection for beneficiaries. If the grantor is not a beneficiary of the trust, the grantor's creditors cannot reach the trust assets because the grantor no longer owns them. The trust can provide creditor protection even if the trustee is given discretion to make distributions to the grantor if it is structured as a domestic asset protection trust (DAPT). Such trusts can be created in Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, Ohio, Oklahoma, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

The rules for DAPTs vary considerably from state to state. For example, some states allow more exception creditors (e.g., divorcing spouses, child support creditors, tort creditors). The states also have different statutes of limitations for when transferred assets are protected. Although numerous states now allow DAPTs, almost all of them have been created under the laws of four states—Alaska, Delaware, Nevada and South Dakota. Of these leading DAPT states, Nevada appears to have the most favorable laws, particularly for taxpayers who wish to use the DAPT to save on state income taxes. For a detailed discussion of the use of Nevada Incomplete Gift, Non-Grantor Trusts (NINGs) to save on state income taxes, see the NING topic in this series.

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