

THE MYTH OF DYNASTY TRUSTS

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A friend recently mentioned that her estate planning attorney said she should have a dynasty trust. That sounds pretty impressive, but how do I know if I should have one?

As clients of mine have discovered, you may already have one.

In its purest and simplest form, a dynasty trust—which has nothing to do with Joan Collins or the Carringtons—lasts for the longest term permitted by law. In Florida, that means 360 years. During that time, generation after generation draws income (and usually principal) from the trust, which would, if well invested, grow to an astronomical amount (perhaps slightly less astronomical once inflation is factored in).

But very little in trusts and estates is pure and simple.

There are countless variations on the dynasty trust theme, and it would be a rare situation in which a family would create a 360-year trust with no flexibility to adapt to what may happen in the future. I think you would agree that there have been a fair number of changes since the island of Manhattan was sold to the Dutch in 1678, and there will probably be a fair number of additional changes (political, social, and family) in the next 30 years when a dynasty trust established at that time would have to terminate (had it been established under current Florida law).

As the original formula is varied, the myth that there is a single magic dynasty trust becomes more apparent. While it is possible that such a trust would be created to last for the longest term possible, it is much more common for these long-term trusts to provide for the ability to be reinvented by every generation. This is done by giving each generation a power of appointment over the trust.

A power of appointment is a right conferred on someone to effect an interest in property that is (or was) owned by someone else. In the dynasty trust context, this means that a child of the creator of the trust, for example, would have the right to determine the manner in which his or her share of the trust is held or distributed upon his or her death. This can be important if, for example, the child has a child with special needs for which special trust provisions, unanticipated by the creator of the dynasty trust, would be appropriate. Or perhaps the creator of the trust made no provision for a “black sheep” of the family who has now turned his or her life around.

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A power of appointment could be used for the benefit of that person.

Even with powers of appointment, the original dynasty trust does not become irrelevant, since the exercise of the power of appointment cannot extend the term of any subsequent trusts beyond the date the dynasty trust would have had to end. The dynasty trust also creates the back-up plan to handle the situation where the power of appointment goes unexercised.

Of course, there is a tax angle here (isn't there always). Because the economics of multi-generational trust planning were not lost on Congress, there has been a system in place since 1986 that limits this type of planning. The system is the generation-skipping transfer tax, which is imposed on a multi-generational trust every other generation. The tax rate is equal to the highest marginal estate tax rate (presently 45%). If every member of every affected generation will be in the highest marginal tax bracket, then maybe it does not matter. However, by carefully designing powers of appointment, it is possible to get the best of both worlds. That is, achieve multi-generational planning while limiting the tax bite to the beneficiary's actual estate tax bracket.

For every rule (especially a tax rule), there must be at least one exception—and the generation-skipping transfer tax follows true in that regard. Every taxpayer has a generation-skipping transfer tax exemption that allows up to \$2 million (scheduled to increase to \$3.5 million in 2009) to be set aside without any generation-skipping transfer tax implications. If care is taken in the design of the trust, this exemption can be leveraged to create a substantial fund that will avoid transfer tax for all 360 years.

Now re-read your present documents. Unless your estate plan does not provide for lifetime trusts for all beneficiaries (which is really a must in these asset-protection-sensitive days), you already have a dynasty trust, or at least a version of it. Congratulations!

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