DYNASTY TRUSTS

Thomas F. Kennedy
KENNEDY & ASSOCIATES
Attorneys-at-Law

Board Certified
Estate Planning and Probate Law -
Texas Board of Legal Specialization

5851 San Felipe, Suite 925
Houston, Texas 77057
(713) 783-7444
(713) 783-6601 (Fax)
E-MAIL: tkennedy@houstonestateplanning.com

DYNASTY TRUSTS

I. **BACKGROUND.** A Dynasty Trust is like having a "family bank" for family members and their descendants over a long period of time. Outstanding growth of the trust corpus is possible.

One of the primary considerations in the management of the Dynasty Trust is the avoidance of wealth transfer taxes. If the trust assets are retained in the trust they will not be subject to transfer taxes for the duration of the trust. A Dynasty Trust is designed so that it will exist as long as the law allows it to exist. The assets in the trust will also avoid probate. A client places assets in the trust, or establishes a trust and the trustee purchases a life insurance policy on the life of the Settlor or Settlors of the Trust.

II. **DUTIES OF THE TRUSTEE.** The trustee will:

a) Emphasize the use of the trust assets rather than the distribution of the assets outright to the beneficiaries.

b) Encourage the beneficiaries to pay for their own consumables or depreciating assets (i.e. food, schooling, autos and other assets that depreciate rather than appreciate in value). Since the beneficiaries have the security of the trust they will do this and thereby reduce their own taxable estates.

c) Have the flexibility to make the trust fit the family and the society as it develops over a long period of time. Flexibility is a key aspect of the Dynasty trust because it is such along term arrangement.

d) The trustee should have the discretion to make loans to the beneficiary rather than distributions.

e) Whenever possible the trust income will be accumulated by the trustee rather than distributed because then the income will also avoid transfer taxes.

In order to encourage the "use" of specific assets by the beneficiaries rather than funding the personal acquisition of the assets by the beneficiary, the trust should contain specific language to permit investment in assets such as homes, artwork, jewelry and other assets which have significant appreciation value. Thus the beneficiary will have the use and enjoyment of the property without the transfer taxes. The free use of the property should not result in imputed income to the beneficiary.

Many candidates for dynasty trusts will be persons with large life insurance policies. Others will be persons who are looking for asset protection.

III. ADVANTAGES OF ASSETS IN TRUST RATHER THAN OUTRIGHT OWNERSHIP.

The beneficiaries may have more benefits if assets are in trust than if they have outright ownership. For example, in the typical "maximum benefit' trust, the beneficiary can have:

1) all of the income;

2) right to principal distributions limited to an ascertainable standard;

3) right to principal distributions the greater of $5000 per year or 5% of the trust principal;

4) the right to ultimately determine who will receive the trust property; and

5) the right to be the sole trustee.

Additionally, the beneficiary can have the advantages of creditor and divorce protection as outlined below under the spendthrift trust discussion. Of course, the beneficiary also has the advantage of avoiding transfer taxes.

However, in the Dynasty trust the discretionary trust will be utilized rather than the maximum benefit trust. Income can be retained in the discretionary trust and thus assets can grow at a greater rate. Additionally the creditor protection is greater in the discretionary trust.

IV. GROWTH POTENTIAL OF ASSETS IN A DYNASTY TRUST.

The following is an example of the growth potential of a contribution of $1,000,000 of assets in a Dynasty Trust over a 120 year period compared to an outright transfer:

Annual After Tax Growth	Value After 120 Years	Value of Property If No Trust *
6.00%	$1,088,187,748	$ 68,011,734
7.00%	$3,357,788,383	$209,861,744
8.00%	$10,252,992,943	$640,812,059

* Assuming an estate tax of 50% every 30 years.

The actual savings potential may be greater than shown because the property received outright will often be reduced further than illustrated because of divorce settlements, creditor attacks and the fact that assets held in trust are less likely to be dissipated.

V. <u>CREDITOR PROTECTION OF THE ASSETS IN THE TRUST.</u> Spendthrift trusts will protect the assets of a trust from the creditors of the beneficiary while the assets are held in trust. To have a valid spendthrift trust the trust must have a "spendthrift" clause.

The envelope of protection for the spendthrift trust is often stronger than a corporate shield. Texas courts have held that:

a) The assets of a spendthrift trust are protected from the judgements and claims of a beneficiary's creditors.

b) In a divorce, one spouse cannot reach the assets of the other spouse which are held in a spendthrift trust created for the other spouse.

c) In one case the Internal Revenue Service could not reach the assets of a spendthrift trust which was created by a husband for his wife. The Internal Revenue Service attempted to reach the assets of the wife's spendthrift trust to satisfy its tax claim and its claim was denied.

d) Texas courts have also denied governmental claims for institutional care and attempts to seek reimbursement from a spendthrift trust.

In order for the assets of the trust to be protected, the trustee must have actual possession of the trust property. Nothing prevents a creditor from pursuing income payments or other property after it has been actually delivered to a beneficiary of the trust. The beneficiary also cannot use the assets of the trust as collateral for a loan prior to his actually receiving the assets of the trust.

There are some limits to the protection of the property that a spendthrift trust may afford. A court may order trustees to make disbursements for the support of a child of the beneficiary. Secondly, the grantor may not establish a spendthrift trust for himself or herself.

A trust which gives the trustee discretionary authority to distribute trusts assets has the best creditor protection. The ultimate in creditor and divorce claims protection is a discretionary trust with an independent trustee. If you eliminate the beneficiaries right to enforce distributions you also eliminate the rights of the creditor.

An example of a valid spendthrift trust would be a trust created by a father for his children. Often these trusts are established for the life of the children which means during the children's life

the assets will not be subject to attachment by creditors, either contractual or tort creditors (i.e. a judgement creditor in an automobile accident or a slip and fall case) and also will not be subject to division by a divorce court should the child ever get a divorce. This provision becomes particularly important considering that fifty percent of the marriages in the United States currently end up in divorce.

An example of spendthrift language in a trust is as follows:

A) **Spendthrift Restriction.** Each trust created under this Agreement is a spendthrift trust. No beneficiary shall have the power to anticipate, encumber or transfer, in any manner, his interest in the trust estate. No part of any trust estate shall be liable for or charged with any debts, contracts, liabilities or torts of a beneficiary or subject to any execution, garnishment, attachment, seizure or other judicial process by any creditor of a beneficiary.

VI. HOW LONG WILL THE LAW ALLOW THE TRUST TO EXIST? Trusts are subject to the Rule Against Perpetuities. This rule limits the length of time that a trust can be in existence. In Texas, if a Trust violates the Rule Against Perpetuities a court will reform the terms of the trust so that it will not violate the rule. The rule uses lives in being at the creation of the trust in order to determine how long the trust can exist before it must terminate. Some commentators suggest that the lives in being that are used should be a large pool (i.e. a large family) that is easily identifiable (i.e. the Kennedy family). Samples of the Rule Against Perpetuities are as follows:

A) **Perpetuities.** In no event will the term of this Trust continue for a term greater than twenty-one (21) years after the death of the last survivor of Trustmakers and all relatives of Trustmakers living on the effective date of this Trust Declaration. Any continuation of the Trust by the qualified exercise of a power of appointment will be construed as the creation of a separate trust and an extension of the Rule Against Perpetuities to the extent permitted by law. A court of competent jurisdiction is to liberally construe and apply this provision to validate an interest consistent with Trustmakers' intent and may reform or construe an interest according to the doctrine of cy pres.

B) **Maximum Duration of Trusts**. Every trust created hereunder must terminate not later than twenty-one (21) years after the date of death of the survivor of the following persons: Settlor, Settlor's Spouse and Settlor's descendants who are living on the date of execution of this Agreement. In the event of such termination, each remaining trust estate shall be distributed equally to the persons entitled to the income from such trust at the time of termination.

VII. ASSETS THAT SHOULD BE PLACED IN THE TRUST. Assets which have rapid growth potential should be placed in the Dynasty Trust. While there are many assets that may fit this description the focus of this discussion centers around the use of life insurance in the dynasty trust. Because life insurance has a high residual value relative to its costs and because of the favorable tax treatment it receives, it is an excellent asset to place in the trust. Life insurance which

emphasizes high death benefits, rather than cash value increases the leverage factor. Second to die policies which usually have significantly lower premiums also increase the leverage.

Sources: Megatrusts, by Richard A. Oshins, State Bar of Texas Advanced Drafting: Estate Planning and Probate Course, (November 1992); A Family Limited Partnership as the Centerpiece of an Estate Plan, by Larry W. Gibbs, Trust and Estates, (September 1992); Megatrusts: Representation Without Taxation, Richard A. Oshins, New York University Proceedings on the Forty Eighth Institute On Federal Taxation (1989); Skipping Generations with Irrevocable Life Insurance Trusts, by Georgiana J. Slade and Jonathan G. Blattmachr, Trusts and Estates, (April 1993); Generation Skipping Transfer Tax Rules Ignore the Crummey Power, by William C. Brackney, Journal of the American Society of CLU & ChFC, (November 1989).