

Dynasty Trusts Under Attack

By LAURA SAUNDERS MARCH 5, 2011 TAX REPORT



It's official: A type of trust used by the wealthy to shelter assets from estate taxes for hundreds of years, or even forever, is under fire.

The proposal, which first appeared a few weeks ago on a hit list of estate provisions in President Obama's 2012 budget, would limit tax-free "dynasty trusts" to 90 years.

States That Allow Dynasty Trusts

Alaska, Delaware, District of Columbia, Idaho, Illinois, Kentucky, Maine, Maryland, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Utah, Virginia, Wisconsin, Wyoming

The chances of passage are practically zero this year, say experts. But taxpayers should know that the idea is in play—and act accordingly. As proposed, the change would apply to new trusts or additions of money to existing ones, but not to those already funded.

Bottom line: If you are considering setting up a dynasty trust, move swiftly. "This proposal reinforces the other reasons for doing so," says Julie Kwon, a partner at McDermott, Will & Emery in Silicon Valley. Among them: the current generous terms of the estate and gift tax—a \$5 million individual exemption and a top 35% rate, both of which are set to expire at the end of 2012.

"We're encouraging people who want these trusts to set them up now," Ms. Kwon says.

Dynasty trusts have gathered steam since the 1986 tax overhaul installed the current version of the "generation-skipping tax." This levy imposes taxes that would be avoided if taxpayers left assets to heirs who are more than one generation below.

Example: Robert, a widower, has a net worth of \$15 million and his heirs include children, grandchildren and great-grandchildren. If he leaves everything to his children and they in turn leave everything to theirs and so on, there could be an estate tax toll with each generation.



Mark Matcho

Robert would like to put his entire estate into a trust and skip layers of tax. But if he does, the generation-skipping tax kicks in and replaces the lost taxes—except for an exempted amount, which is currently \$5 million per individual or \$10 million per married couple. That \$5 million can be pumped up using discounts, life insurance and other leveraging techniques.

Dynasty trusts push that generation-skipping tax exemption to the max, putting the exempted amount beyond the reach of estate taxes for the life of the trust. That, in turn, means the heirs don't have to "spend" their own exemptions on those assets. These trusts are now allowed in 23 states and the District of Columbia (see table), to the delight of companies that charge fees to manage them. Taxpayers don't have to live in a state to put a trust there.

To enable these trusts, most of the states allowing them had to get rid of an old common-law principle called the "rule against perpetuities," which allowed trusts to exist only for about 90 years. The Obama administration proposal would reinstate this old principle in a way by removing the federal tax exemption after 90 years. So the trust can go on indefinitely, but the exemption can't. (The pass applies to taxes on wealth transfers, of course; annual income taxes are always due.)

According to Ms. Kwon, "more than half" her clients choose to set up these trusts when presented with the option.

Opponents of dynasty trusts often object to them on policy grounds. Prof. Ray Madoff of Boston College Law School fears they will help create a new aristocracy with access to tax-free, creditor-proof wealth. She also worries they benefit bankers as much as families: "Bankers are using these trusts as a decoy to line their own pockets."

Attorney Beth Kaufman of Caplin & Drysdale in Washington raises a practical issue: "Most of my clients like to know something about the people they are leaving money to." According to a 2010 report written by University of Michigan law professor Larry Waggoner for the American Law Institute, which endorsed the restriction on dynasty trusts, the average person can expect to have 450 descendants 150 years after a trust is established. And a parent's genetic relationship to a child can be 50%, while the one with an heir six generations removed is no more than 1.6%.

Attorney Howard Zaritsky, a consultant to other estate lawyers, believes the main benefit of long-lived trusts is that they protect family assets from being dispersed by creditor claims and divorce. For most trusts, he suspects, 90 years will be long enough.

For those opting into dynasty trusts, all the experts urge care in drafting because the distant future is full of unknowns. In particular, it should allow for the removal of the institution handling the trust so heirs won't be captive to high fees or poor performance. Says Mr. Zaritsky: "Between the trustee and beneficiaries, there needs to be a balance of powers worthy of James Madison."

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