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Using Dynasty Trusts to Benefit the Client, Not Just the Client's Beneficiaries

By Briar K. Stahl

Most estate planners today attempt to help alleviate the transfer taxes owed by wealthy families through various wealth shifting techniques to the children and future generations. Most commonly, a client will set up a dynasty trust for the benefit of his children and descendants and sometimes his spouse. The trust will be an irrevocable dynasty trust structured to last for as long as state law will allow through the use of generation skipping provisions. The client will then shift his assets (by gift or sale) into this trust for the benefit of the beneficiaries. However, since the client is the grantor of the trust, he cannot be a beneficiary and will therefore lose access to the assets shifted into this trust. While this type of planning can be very effective to protect wealth for the client's beneficiaries, this planning does not have a direct financial benefit for the client. This article proposes that through the use of a properly structured dynasty trust, clients can continue to benefit from the use and enjoyment of their own assets while protecting them from virtually all creditors and the transfer tax system.

Locating a grantor of the dynasty trust

The first step in forming this kind of dynasty trust is locating a person willing to set up the dynasty trust for the benefit of the client. Technically, the grantor of the trust can be anyone other than the client, however, the author recommends locating a person who would naturally be inclined to benefit the client, such as a parent or a grandparent. Also, the grantor must be capable and willing to gift a certain amount of money into the trust for the benefit of the client. Having a person other than the client form the dynasty trust allows the client to be a beneficiary of the trust and benefit from the assets owned by the trust.

Structuring the dynasty trust

The dynasty trust shall be structured as an irrevocable trust, with the client's parent or grandparent (or some other person) as the grantor. The client will either be the sole Trustee or will be a co-trustee with powers to make investment decisions. The client will be the initial "primary" beneficiary and the client's spouse and children or more remote descendants may also be initial permissible distributees. The language permitting distributions to the beneficiaries will either be fully discretionary or will be limited to an ascertainable standard such as "health, education, maintenance and support" (HEMS). Trusts limited to an ascertainable standard are typically called "support trusts." If the distribution language is limited to an ascertainable standard, the client may be the sole trustee and may make all financial and distribution decisions over the trust. This trust drafting philosophy may be very attractive to many clients because of the elements of control the client will have over the trust. If the trust is not limited to an ascertainable standard, but instead allows distributions for any reason (fully discretionary trust), someone other than a beneficiary or potential beneficiary must be appointed as the trustee or as a co-trustee with the power to make distribution decisions. For tax purposes, this "distribution trustee" is often limited to anyone other than a related party or a subordinate employee. *IRC §672(c).*

Enhanced creditor protection of a fully discretionary dynasty trust

At first glance, a fully discretionary trust requiring the role of a distribution trustee may not be as attractive to clients as a trust that is limited to an ascertainable standard where the client can be the sole Trustee. However, there is an extremely important difference regarding the levels of creditor protection that each kind of dynasty trust offers. While both support trusts and fully discretionary trusts protect the assets of the trusts from nearly all creditors, there are a few exception creditors than can pierce through a support trust, whereas assets held in a fully discretionary trust with the distribution power held by the distribution trustee, are protected from virtually all creditors. The main exception creditor of a support trust is a divorcing spouse. *In re Threewitt, 20.B.R. 434 (Bkrtcy. D. Kan. 1982).* Since the divorce rate today is well over fifty percent, and since the dynasty trust is drafted to last for generation after generation where there will inevitably be numerous divorces amongst the beneficiaries, all estate planners should be counseling their

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clients on the creditor protection benefits of using a fully discretionary dynasty trust with distributions in the hands of an independent distribution trustee.

Keeping control in the hands of the beneficiary/client

If the client's primary estate planning goal is to protect his hard–earned wealth from the transfer tax system and from all creditors, including divorcing spouses, then a discretionary trust is by far the best option. However, this option will only be attractive to the client if he will remain in control of the assets of the trust. The elements of control that can be placed in the hands of the client in his capacity as both the beneficiary and the "investment trustee" will give him virtual control over the assets of the trust similar to holding the assets free of trust.

First, the client will have the power to remove and replace the trustees for any reason. *Priv. Ltr. Rul. 97-46-007 (Aug. 11, 1997)*. While placing the distribution decision in the hands of a distribution trustee seems to take away control from the beneficiary, if he has the power to remove and replace the distribution trustee, he still remains in full control. If the distribution trustee is ever uncooperative, the client can simply remove the distribution trustee and appoint a new distribution trustee.

Second, if the client/beneficiary holds the role of investment trustee, he will be in charge of all investment decisions of the trust assets. The "Trustee Powers" section that typically appears in all dynasty trusts can be drafted to give the investment trustee the power to invest the trust assets any way that he pleases. Specifically, the author recommends drafting the trust such that it opts out of the "Prudent Person Rule" to give the investment trustee full investment power over the trust assets. Therefore, the client, in his capacity as the investment trustee can use and invest the assets of the trust in a fashion that is equivalent to outright ownership of the trust assets.

Lastly, the client in his capacity as the beneficiary of the trust can be given a very broad special testamentary power of appointment over the trust assets. A special testamentary power of appointment is the power to change how the assets are to pass after the client's death. The power of appointment can be so broad as to allow the client to appoint the assets of the trust to anyone other than himself, his estate, his creditors or the creditors of his estate. *IRC §2041(b)(1)*. By the beneficiary holding this broad special testamentary power of appointment, the terms of the trust are not locked, but can be continually changed just as if the client owned the assets free of trust.

Using the dynasty trust most effectively

Once the dynasty trust is formed and funded, the client can use the trust in various ways. The dynasty trust can be structured as income taxable to the client as the beneficiary of the trust. This is done by giving the client/beneficiary a crummey power of withdrawal over the entire amount of all gifts to the trust. *IRC §678(a)(1).* If the income generated by the trust is taxable to the beneficiary, the beneficiary may interact with the trust on an income tax-free basis. *Rev. Rul. 85-13.* One of the ways the client may interact with the trust is to sell discountable assets into the trust in exchange for a promissory note. Discountable assets are those where the sum of divided partial interests are valued less than the undivided asset as a whole. Discounts are typically given for lack of marketability and lack of control. By selling discounted assets into the trust, the client has reduced his estate for estate tax purposes and protected the shifted assets from virtually all creditors, yet still maintains control over the assets. In addition, the client may still benefit from the assets in the trust at the discretion of the trustee.

The client can also use this dynasty trust as a powerful investment tool by investing in assets likely to appreciate or in a new business venture inside the trust, rather than in his own estate. The wealth generated by the investments would be inside the dynasty trust, protected from creditors and the transfer tax system. By simply having a person other than the client set up a dynasty trust for the benefit of the client, his spouse and descendants, instead of having the client set up the trust for the benefit of his spouse and descendants, estate planners can help a wealthy client achieve his wealth-shifting and asset protection goals while allowing him to continue benefiting from his hard-earned wealth. C

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