

While many people prefer to leave an inheritance to their child or grandchild in a trust, they incorrectly assume that once a minor reaches maturity a trust is no longer needed or advantageous. On the contrary, significant benefits can be obtained by leaving the assets in trust for the beneficiary, including shielding the assets from creditors' claims, protecting them from claims by an ex-spouse in a divorce proceeding, and avoiding future estate taxes on the assets. Trusts that provide these benefits for the lifetime of the beneficiary are often referred to as "*Dynasty Trusts*," "*Generation-Skipping Trusts*," "*Legacy Trusts*," and "*Personal Asset Protection Trusts*." For the purpose of this FAQ, we will refer to this type of trust as a Dynasty Trust.

What are my options for leaving assets to a child?

There three main ways to leave assets to your children: (1) outright, with no strings attached; (2) in a standard testamentary trust, which terminates at a specified age; or (3) in a Dynasty Trust, which lasts for the beneficiary's lifetime.

What if my child is a minor?

If you leave an outright gift to a minor child, the court will have oversight over the funds until your child attains age 18, at which time, he/she will receive full access to the funds. For most people, this is not an ideal option.

What exactly is a trust?

A trust is a legal arrangement that provides for the ownership, management, and distribution of assets. Think of a trust as a box into which someone places assets. The person placing the assets into the trust is known as the *grantor* of the trust. The person who oversees the property in the box is the *trustee*. Finally, the person who receives the benefit of the property held in the box is known as the *beneficiary*.

How is a standard trust administered and distributed?

All trusts can be completely customized, but in general, a standard trust provides for distributions of income and principal to be made to the beneficiary for his/her health, support, maintenance, and education during the trust term. At a certain age (e.g., at age 30), the trust will terminate and the remaining principal will be distributed to the beneficiary. Alternatively, the trust can distribute in stages (e.g., 1/3 at ages 25, 30, and 35).

Can I include provisions for additional distributions?

Yes, as mentioned earlier, these trusts can be customized as much as you would like. Examples of some commonly requested provisions include:

- A certain percentage or dollar distribution when a child obtains an undergraduate degree;
- A distribution when a child gets married or has a baby;
- Distributions to allow the beneficiary to travel to visit grandparents or for grandparents to visit the child;
- Distributions to match a beneficiary's earned income;
- Withholding of distributions if a child gets married without a prenuptial agreement; and
- Withholding of distributions if a child is abusing drugs or alcohol or has a gambling addiction.

What is a Dynasty Trust and how is it different from a standard trust?

Dynasty Trusts operate like standard trusts, and can make payments as desired for the beneficiary's health, support, maintenance, and education. However, rather than terminating at a specified age and distributing the remaining assets to the beneficiary, Dynasty Trusts do not terminate – they last for a child's lifetime. However, at a certain age, many grantors choose to have the beneficiary serve as his/her own trustee, giving the beneficiary control over investments and distributions. Dynasty Trusts have advantages that standard trusts do not. Dynasty Trusts can (1) provide for future generations; (2) shield the trust assets from each generation's creditors (including potential spousal claims during a

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divorce); and (3) enable a portion of the trust to escape estate taxes otherwise due on the passing of each succeeding generation.

A typical example would be George and Jane. Upon their deaths, they wish to leave their \$10 million estate to their two children, Judy and Elroy. Judy is financially responsible, but Elroy is young and needs more years to mature into what they hope will be a productive member of society. They decide to leave half of the estate to each child in a Dynasty Trust. They name Judy as trustee of her own trust, so after their deaths, she can manage the assets and make distributions to herself for her needs. However, George and Jane name an independent trustee for Elroy's trust to serve until Elroy reaches age 35. The independent trustee will ensure that Elroy receives distributions from the trust as needed for his health, support, maintenance, and education. If Elroy needs a vehicle, the trustee may purchase a reasonable suited vehicle for him, such as a Honda, rather than the Ferrari that Elroy really desires. The trustee would also be able to make additional distributions at his/her discretion, such as investing in a business in which Elroy will work.

How does a Dynasty Trust provide for future generations?

A typical Dynasty Trust will provide for a beneficiary during his/her lifetime and upon the primary beneficiary's death, the trust will be divided into subtrusts – one for each of the beneficiary's children. Upon the death of a beneficiary's child, the trust will continue to divide into subtrusts for the next generation, continuing down the bloodline until no funds remain.

Is there a way to allow a beneficiary to re-direct where the trust goes following his/her death?

Yes, the grantors may give each beneficiary a *testamentary power of appointment* over the remainder of his/her trust. This power allows the beneficiary to give the remaining trust assets to someone other than his/her children. The power may be unlimited, allowing the beneficiary to redirect the remaining trust estate to any individual (e.g., a spouse) or any charitable organization, or the power may be limited, allowing the beneficiary to give the remaining trust estate to only certain people (e.g., only to the descendants in the lineal bloodline of the grantor).

How does a Dynasty Trust protect the Trust assets from creditors' claims?

In this litigious era, Dynasty Trusts can provide an invaluable shelter for beneficiaries in high-risk professions, such as physicians, paramedics, contractors, architects, pilots, lawyers, or other businesspersons engaged in any profession that would expose him or her to lawsuits. While you cannot place your own assets in a Dynasty Trust to protect them from your creditors, someone else can create and fund a Dynasty Trust for you. Because you are not deemed to own the assets someone else gifts to you in trust, the assets will not be reachable by your creditors. A Dynasty Trust of the kind suggested here can provide a financial reserve that can be handed down from one generation to the next.

How does a Dynasty Trust protect the trust assets from spousal claims?

Often parents are concerned that family assets will wind up in the hands of a child's spouse upon a child's death or divorce. While any assets you leave to a child will be his or her separate property, children sometimes commingle inherited assets with community assets, causing such assets to become subject to community claims over time. Additionally, in Washington, all assets owned by a married couple, including separate property and community property, are before the court and available for division in a divorce proceeding. Because assets in a Dynasty Trust are not owned by a child, they are not available for court division in a divorce. Therefore, leaving assets to your child in a trust will enable your child to retain these assets free of any spousal claims.

How do assets in a Dynasty Trust escape estate tax at each successive generation?

Assets you own or have certain rights over are included in your taxable estate at your death. However, as long as the Dynasty Trust is properly drafted, a beneficiary can have access to, and control over, the trust assets, but the beneficiary will not own the assets. This allows the trust assets to escape inclusion in the beneficiary's taxable estate, bypassing the federal estate tax (at a flat 40% rate) and the Washington State Estate Tax (at rates from 10% to 20%).

To illustrate, assume that George and Jane set aside \$5,000,000 (after taxes) for their daughter, Judy, in a Dynasty Trust. Judy consumes only the income during her lifetime and conserves the principal so that \$5,000,000 passes to Judy's son, and George and Jane's grandchild, tax-free. Had George and Jane left the funds outright to Judy, they would have been included in her estate, and subject to possible federal and state estate taxes, before passing to her son. Assuming a flat 40% tax rate, the funds would have been eroded by \$2,000,000, leaving \$3,000,000 for Judy's

son. Assuming, like Judy, her son consumed only income and left the principal intact, and assuming another 40% tax bracket, the tax at Judy's son's death would be \$1,200,000, leaving only \$1,800,000 of the initial \$5,000,000 remaining. Avoiding the tax erosion at each generation produces phenomenal savings.

What is the generation skipping transfer tax and how does it affect a Dynasty Trust?

The estate tax was created to tax a person's wealth as it passed to the next generation. Many wealthy taxpayers passed assets to their children during life, and to avoid a level of estate tax, began to pass their estates to their grandchildren. The IRS realized that instead of collecting two taxes (a tax on the transfer of assets from parents to children and another tax on the transfer of assets from children to grandchildren), they were only getting one tax (from parents to grandchildren). To compensate for this, the IRS created a Generation Skipping Transfer Tax (*GST tax*). This tax is imposed on all transfers made by a donor to a "skip person" (a person who is in a generation that is more than one generation below you), such as a transfer from a grandparent to a grandchild. The GST tax rate is always equal to the highest estate tax rate. Currently, the estate tax rate is a flat 40%, so the GST tax rate is 40%. By imposing such a tax, the IRS has tried to eliminate the tax benefits of leaving assets to your grandchildren rather than to your children.

However, like the estate tax, the IRS provides an exemption against GST Tax. Each taxpayer can pass up to \$5,000,000 (this amount is adjusted for inflation annually and in 2017, it is \$5,490,000) to a skip person free of estate tax. This is known as the *GST exemption*. While the GST tax rate and exemption are the same amounts as the federal estate tax rate and exemption, they should not be thought of together. These two taxes run parallel and a donor who makes a transfer to a skip person in excess of his/her exemption, will need to pay both taxes.

To illustrate, suppose George has an \$8,000,000 estate which he leaves to his grandchild, Astro. George's estate will be subject to estate taxes on the amount in excess of his lifetime exemption (\$5,490,000 in 2017) and he will also pay GST tax on the amount in excess of his GST tax exemption (also \$5,490,000 in 2017). In addition, assuming he is a Washington resident, he will pay state estate tax on the amount in excess of his state estate tax exemption (\$2,129,000 in 2017).

The GST exemption is pivotal for the creation of a Dynasty Trust. In order to have the Dynasty Trust pass from generation to generation free of state estate tax, federal estate tax, and GST tax, the Dynasty Trust should be funded with an amount up to the donor's GST tax exemption. The trust principal and all future growth, will be excluded from future estate and GST tax as the trust assets are available to each successive generation. If the assets of the trust will be greater than the amount of the GST exemption at the time of formation, a well drafted trust document should allow the trustee to divide the trust into two subtrusts, with one that will hold the GST exemption amount and one that will hold the balance. Distributions from the subtrust that holds the GST exemption amount will not be subject to tax at each successive generation. Distributions from the trust that holds the amount that is over the GST exemption amount will be subject to tax upon distribution, but the corpus will remain creditor protected and protected from spousal claims.

Can the beneficiary control the assets of the Dynasty Trust?

Assuming the beneficiary is a financially responsible adult, you may name the beneficiary as trustee of his/her own Dynasty Trust and allow the beneficiary to manage and invest trust property for his/her own benefit. Typically, the trust permits distributions of trust income and principal only to the extent needed for the health, support, maintenance, and education of the beneficiary or his or her family. The beneficiary may also receive distributions to start a business or make an investment. If the beneficiary is not responsible, the grantor can select a relative, friend, corporate, or other independent trustee to manage the trust and make distributions to the beneficiary.

Are Dynasty Trusts too good to be true?

The benefits of a Dynasty Trust are potentially enormous, and such an arrangement can perpetuate control and flexibility to the degree desired. Many clients wonder how this can be possible, why the IRS has not challenged this idea, and why they have not heard about this before. The truth is that this technique has been around for decades. As the exemptions have increased and as society has become more litigious, these trusts are gaining popularity. Because the technique depends on successfully threading a course through extremely complex income and estate tax rules and because the arrangement may last for several generations, it must be carefully thought through and drafted.

How do I get started setting up a Dynasty Trust for my children and their descendants?

The first step is to contact one of the attorneys in Helsell Fetterman's Estate Planning and Probate Group. We will send you some background information and an initial questionnaire to get you started with the process. We will then set up a time to discuss your family circumstances, specific estate planning goals, and tax concerns.

To learn more, contact our

Estate Planning & Probate Group

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