

# Dynasty Trusts and Life Insurance: New Opportunities for Leverage

An irrevocable dynasty trust that uses life insurance to leverage the grantor's GST exemption can shelter substantial assets from estate and GST taxes for many years. This article examines this powerful estate planning technique.

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**M**ost individuals' assets pass from one generation to the next (parent to child) subject to estate tax, and then pass from that generation to the next (child to grandchild) subject to estate tax again, and so forth. The transfer from each generation to the next gives the IRS another estate-tax bite at the apple, so to speak. Historically, sophisticated advisors to wealthy families used a technique that allowed clients to accumulate and distribute family wealth across many generations with minimum gift or estate tax impact.

By creating a trust that provided for the descendants of the grantor, these families could benefit a number of generations with a single gift. These trusts often would permit distributions to any of the beneficiaries at any time, which sometimes had the effect of jumping over intermediate generations and avoiding one or more rounds

of gift or estate tax. One bite at the apple was all the IRS got, at least with gift and estate taxes.<sup>1</sup>

This technique was weakened by the enactment of the generation-skipping transfer (GST) tax provisions. These provisions (Code Sections 2601-2664) mandate a tax on transfers to a transferee who is more than one generation below the transferor's generation. The GST tax is imposed on transfers during life and at death, in addition to any gift or estate tax imposed on the transfer. A dynasty trust works within this statutory framework to maximize the time that estate and gift taxes can be avoided or deferred.

## **GST tax**

Because dynasty trusts are distinguished by a focus on avoiding GST tax, any discussion of dynasty trusts must begin with a brief outline of federal GST taxation. The GST tax provisions basically impose, on every "generation-skipping transfer" (as defined by the Code), a tax at the highest estate tax rate in existence at the time of the transfer (currently 49%).<sup>2</sup> Every taxpayer is allowed a "GST exemption" that may be allocated to transfers by the taxpayer that are or will be subject to GST tax. The GST

exemption is \$1,120,000 per person in 2003.

*Generation-skipping transfers defined.* A "generation-skipping transfer" is generally a transfer from a transferor to a transferee that is more than one generation below the transferor's generation (a "skip person"). A skip person can be (1) a natural person or (2) a trust if all interests in the trust are held by skip persons or if there is no person holding an interest in the trust and at no time may a trust distribution be made to a nonskip person.

A generation-skipping transfer may take the form of a "direct skip" (a transfer to a skip person), a "taxable termination" (a termination of an interest in trust, which then passes to a skip person), or a "taxable distribution" (a distribution from a trust to a skip person). Transfers in trust are treated a little differently from outright gifts to an individual skip person (such as a grandchild). For example,

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<sup>1</sup> Earnings on the principal from such trusts would be subject to income tax, whether distributed or retained by the trust.

<sup>2</sup> Sections 2641 and 2001. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the maximum estate tax will gradually be reduced through 2009, after which time, estate and GST taxes will be repealed for the year 2010. EGTRRA provides that after 2010, estate and GST taxes will be reinstated at their 2001 rates.

an outright annual exclusion gift to a grandchild under Section 2503(b) is not subject to GST tax. In contrast, a transfer in trust that falls within the gift tax annual exclusion is nonetheless subject to GST tax unless the requirements of Section 2642(c)(2) are met.

The allocation of GST exemption allows all or a portion of a transfer to pass free of GST tax, as determined by the *inclusion ratio*.<sup>3</sup> The inclusion ratio is simply one minus a fraction produced by dividing the amount of GST exemption allocated to a transfer by the amount of the transfer. Thus, suppose that \$2 million of assets is transferred to a trust for the grantor's children and grandchildren, and \$500,000 of GST exemption is allocated to the transfer. Under these facts, the inclusion ratio would be  $1 - (500,000/2,000,000)$  or 1 minus 1/4, which is 3/4. As a result, GST tax will be imposed on three-quarters of every distribution to a skip person. Assume instead that this transfer was an outright gift to a grandchild. In this case, GST tax would apply to \$1.5 million of the transfer, producing a GST tax of \$735,000 (at a 49% GST tax rate).

If a trust is anticipated to last for several generations, the GST tax can be staggering. For this reason, most planners strive to allocate GST exemption to a trust so as to produce an inclusion ratio of either zero (in which case no distributions from the trust will ever be subject to GST tax), or one (in which case all distributions to skip persons would be subject to GST tax).

#### Irrevocable life insurance trusts

Although a dynasty trust may seem complicated, it is fundamentally a specialized irrevocable trust—usually an inter vivos trust, but sometimes testamentary. Furthermore, because the use of life insurance purchased by the trustee of the dynasty trust provides an opportunity for enormous leveraging of the GST exemption, a dynasty trust with life insurance is a special kind of irrevocable life insurance trust (ILIT).

As the name implies, an ILIT is an irrevocable trust that contains provi-

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sions that authorize the trustee to purchase and maintain a life insurance policy, and that facilitate the ownership of the policy.

#### The concept

**What is a dynasty trust?** In most respects, a dynasty trust is the same as the typical ILIT described above. However, because of the power of leveraging the GST exemption with life insurance, a dynasty trust is usually crafted with the intention that the trust will own life insurance and will stay in existence for at least several generations. While a typical ILIT (which is not a GST trust) may allow the first generation of beneficiaries broad power to receive distributions during their lives or to direct the disposition of the assets remaining at the death of such beneficiaries, a dynasty trust takes a much longer view. Frequently, the trust will allow discretionary distributions by the trustee to any of the grantor's issue, including children, grandchildren, and so forth.

**Why does it work?** The goal of a dynasty trust is to pass the greatest amount of assets to as many successive generations as possible. The dynasty trust is able to accomplish this objective for two primary reasons: (1) only GST tax-exempt assets are transferred to the dynasty trust, and (2) these assets are then leveraged with life insurance. With an inclusion ratio of zero, the trustee may make distributions to any of the beneficiaries without GST tax implications. Assets retained by the trustee may be managed (and grown) for future distributions to future generations. Life insurance may allow the trustee to use the GST exemption to shield assets worth several times the amount of GST exemption allocated to the trust.

One limitation of concern to long-term trusts (such as dynasty trusts) is

the rule against perpetuities. Although this rule is based on common law, most states have adopted the rule, which generally limits the duration of trusts to three or four generations, depending on how many beneficiaries are alive when the trust is established.<sup>4</sup> In recent years, a number of states have abolished the rule against perpetuities, allowing trusts domiciled in those states to have potentially unlimited duration.<sup>5</sup>

**Example.** A grantor establishes a dynasty trust and contributes to the trust corporate stock worth \$1,120,000—i.e., the amount of his GST exemption. Assume that the trust assets appreciate at an annual rate of 7%, and that income of 5% is paid to the current beneficiaries, who are the issue of the grantor (including children, grandchildren, and great-grandchildren). The trust beneficiaries can receive distributions of the annual income from the trust, beginning with \$56,000 in the first year and growing to more than \$120,000 by the 50th year. At the same time, the trust principal will grow from \$1,120,000 to roughly \$2.5 million by the 50th year. Income distributions will be includable in the gross income of the beneficiaries, but distributions of principal may or may not be income tax-free to the beneficiaries. None of the distributions will be subject to GST tax.

The grantor can leverage his initial contribution of the amount of his GST exemption even further by using life insurance. If, instead of corporate stock, the grantor in the preceding

<sup>3</sup> Sections 2641 and 2642.

<sup>4</sup> The common law rule against perpetuities specifies that no interest is valid unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest. Most states have codified the rule against perpetuities, however, and the variations of the provisions are legion. Some states have enacted the Uniform Statutory Rule Against Perpetuities, which generally permits a trust to last 90 years.

<sup>5</sup> States that have abolished the rule against perpetuities include: S.D., Wis., Idaho, Alaska, Del., Ariz., Ill., Md., Me., R.I., N.J., Fla. (up to 360 years), Va., and Ohio. Other states are considering eliminating the rule against perpetuities.

example contributed \$1,120,000 in cash, which was applied to a survivorship life insurance policy on the grantor and his spouse, the numbers change dramatically. Suppose that the grantor contributes \$1,120,000 cash to the trust, and the trustee purchases a \$3 million universal life policy on the grantor. Also assume that the grantor dies 20 years later, at his life expectancy.

Because most of the income from the initial cash gift is applied to the life insurance premium, the trust beneficiaries receive less income from the trust in the early years (around \$22,000 in the first year). However, after the trust receives death benefit from the insurance policy, the trust income actually distributed grows to more than \$300,000 in the 25th year (when the trust principal is more than \$4.5 million).<sup>6</sup> In the 50th year, distributions exceed \$1.6 million and trust principal can grow to almost \$25 million. Distributions of the income will be includable in the gross income of the beneficiaries (and deductible to the trust), and the \$25 million will ultimately pass to the beneficiaries income tax-free. None of the distributions will be subject to GST tax.

#### Increases in GST exemption

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the GST exemption (along with the estate tax exemption) will increase from \$1.5 million to \$3.5 million, beginning in 2004 through 2009. In addition, EGTRRA added Code Section 2642(g), which provides relief for late elections to allocate GST exemption, and allows substantial compliance with the rules for allocation of GST exemption under Section 2632. (The benefits of this new provision are described below in connection with Ltr. Rul. 200227017.) However, unless EGTRRA is extended after 2010, the GST exemption will go

<sup>6</sup> This projection assumes that after the death of the grantor, the trust earns income at 7% after tax and distributes 5% each year to the beneficiaries.

<sup>7</sup> The trust also required that there be at all times an unrelated independent trustee.

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back to being indexed for inflation in 2011.

#### Common scenarios

**Funding a dynasty trust.** The current GST exemption of \$1,120,000 per person as well as the scheduled increases in GST exemption under EGTRRA represent a tremendous opportunity for clients to shelter substantial amounts from GST tax via dynasty trusts. If the grantor of a dynasty trust funded with life insurance allocates his GST exemption to all lifetime gifts made to the trust (including all gifts made to cover premium payments), the entire death benefit of the insurance policy owned by the trust (as well as all other trust assets) will be exempt from GST tax.

**IDITs.** GST exemption can also be used very effectively in conjunction with intentionally defective irrevocable trusts (also known as defective grantor trusts). IDITs can be funded with a combination of life insurance and other assets, such as stock or partnership interests. An IDIT will often be funded with an initial gift by the grantor, and the trustee will then purchase stock or partnership interests from the grantor on an installment basis. Because GST tax applies only to gratuitous transfers and not to sales or loans, the grantor would need to allocate GST exemption only to the initial gift (and any subsequent lifetime gifts), but all the trust assets can still be exempt from GST tax, if the allocation is done correctly.

**Split-dollar/loans.** Clients sometimes consider approaches such as split-dollar or a loan to reduce the gift tax cost of funding an ILIT. These techniques basically involve an agreement between the trustee of the ILIT and

another party (the grantor, a family member, or some third party) under which the other party agrees to advance the premium payments in return for some future payment (e.g., aggregate premiums paid, cash surrender value, etc.). The grantor needs to give to the dynasty trust only the annual term cost or interest cost, because the balance of the premium will be paid by the split-dollar collateral assignee or by the lender.

These techniques are particularly useful for clients who are purchasing insurance policies with very large premiums. The use of GST exemption with these approaches adds additional leverage to the transaction. Because the grantor is typically giving a much smaller amount to the trust during life, the grantor would need to use only a corresponding amount of GST exemption to exempt the trust assets from GST tax. This approach can provide the greatest leverage if the loan or collateral assignment is repaid from the death benefit, rather than from a lifetime gift.

#### Recent developments

In Ltr. Rul. 200213013, the IRS determined that the election by married taxpayers to “split” gifts to a trust under Section 2513, and the concurrent allocation by each taxpayer of a corresponding amount of GST exemption, did not cause inclusion of the trust assets in the nongrantor spouse’s estate for estate tax purposes. The taxpayers established a dynasty trust for the benefit of their issue. The nongrantor spouse was the Family Trustee<sup>7</sup> of the trust. Although the nongrantor spouse was not a current beneficiary of the trust, she could become one by surviving all lineal descendants of the taxpayers. The Family Trustee’s authority to make distributions to herself was limited by an ascertainable standard.

The IRS concluded that, for gift and GST tax purposes, the gifts to the trust were considered made one-half by each spouse pursuant to the spouses’ election under Section 2513. However, for purposes of determining estate tax inclusion under Sections 2033,

2035-2038, and 2041, the nongrantor spouse made no actual gift to the trust. This conclusion—together with the limitation of the nongrantor spouse's authority to make any distributions to herself to an ascertainable standard—meant in this case that the assets would not be included in the nongrantor spouse's estate for estate tax purposes.

In Ltr. Rul. 200227017, the IRS applied new Section 2642(g) for the first time to approve a late allocation of GST exemption to a trust. In this letter ruling, married taxpayers established a dynasty trust for the benefit of their children and grandchildren. The couple made annual gifts to the trust, which provided for Crummey withdrawal powers. The taxpayers' accountant mistakenly believed that (1) gifts within the gift tax annual exclusion were not subject to GST tax, and (2) the couple did not need to allocate any GST exemption to the transfers to the extent the gifts were for the benefit of their children. Consequently, the accountant made no affirmative allocation of GST exemption to the gifts to the trust on the appropriate gift tax returns.<sup>8</sup> One of the taxpayers died with unused GST exemption remaining after the executor had made allocations of GST exemption on the estate tax return.

The IRS granted the taxpayers an extension of time to allocate their GST exemption under new Section 2642(g). The IRS concluded that the taxpayers had acted in good faith and in reliance on their tax advisor. In granting the

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extension, the IRS found that the interests of the government would not be prejudiced. Moreover, the IRS allowed the late allocation to be based on the value of the gift *at the time of the transfer* rather than at the time of the late allocation.

**Problems to avoid**

To ensure that a trust's proceeds are fully exempt from GST tax, a client and his advisors should be careful of two common pitfalls: (1) the grantor should allocate GST exemption to all gifts to the trust in a timely manner, including gifts that qualify for the annual exclusion, and (2) the total lifetime gifts to the trust should not exceed the grantor's available GST exemption. While the first pitfall may be able to be remedied by a late allocation of GST exemption, the allocation of GST exemption generally must be based on the value of the gift on the date of the allocation, rather than on the date of the gift. Accordingly, the grantor may not have sufficient GST exemption to cover gifts to the trust, if the allocation is not done in a timely fashion.

The second pitfall will result in a trust that has an inclusion ratio greater than zero. Therefore, any transfers from the trust to beneficiaries that are skip persons will be sub-

ject to GST tax when the distribution is made. A taxable termination of the trust will also result in GST tax. Insurance advisors should be particularly aware of this issue in order to prevent total premiums from exceeding the grantor's available GST exemption. Many trust instruments allow the trustee to divide the trust into two subtrusts—one that is GST tax-exempt (for the grandchildren and later generations), and one that is not GST tax-exempt (for the grantor's children). Nevertheless, it is preferable to keep the entire trust exempt from GST tax, if possible.

**Conclusion**

With careful analysis and planning, a taxpayer can ensure that his or her heirs can enjoy the benefits of the donor's gifts at a minimum tax cost. An irrevocable trust funded with the amount of the taxpayer's GST exemption—especially when that exemption is leveraged with life insurance—can be one of the most powerful estate planning devices available to clients. Earmarking a portion of the estate for a family dynasty trust and shielding that portion from GST and estate taxes can produce astonishing results for many generations to come. ■

<sup>8</sup> Although GST exemption would in many circumstances be automatically allocated under Section 2632 to transfers to a dynasty trust, in this case it was not. The taxpayers' timely filed gift tax return, which allocated no GST exemption to the transfers, may have been deemed an election under Section 2632(c)(5) not to allocate GST exemption.

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