

TRUST TOPICS

October 2008

Dynasty Trusts under Delaware Law

This *Trust Topics* discusses a number of issues related to generation-skipping trusts, including how to minimize the effect of transfer taxes, the best ways to fund the trust and appropriate investment management strategies.

When considering how best to pass on your wealth to future generations, there is one exemption in the transfer tax law that merits close attention: the lifetime exclusion amount. The lifetime exclusion allows you to gift up to \$1 million during your lifetime without incurring either a gift or generation-skipping transfer (GST) tax—a flat tax imposed on property transferred to grandchildren or more remote descendants.

In 2008, the law allows for a larger exemption from GST tax—\$2 million—but increasing your lifetime transfer to that amount may result in an unwanted gift tax. Together, spouses may shelter up to \$2 million from GST tax without adverse gift tax consequences. Over the next several years, the rate of tax and amount of exemption will continue to change. See Chart A for a description of those changes.

As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001, the GST exemption rose in 2004, and the tax rate was reduced, as shown in Chart A. *For ease of discussion, we will use a \$1 million exemption for examples in this piece.*

By placing up to \$1 million in a generation-skipping trust—sometimes referred to as a dynasty trust—designed to benefit multiple generations, you can take maximum advantage of this exemption. Because a trust is created under Delaware law, it can last indefinitely.

TRANSFER TAXES

There are three different types of transfer taxes that can affect the decision of how to set up and fund a dynasty trust.

Gift tax is imposed upon the value of gifts made during the giver's lifetime. This is somewhat mitigated by an annual gift tax exclusion of \$12,000 per year (indexed for inflation), per beneficiary. The exclusion allows you to give annual gifts of up to \$12,000 (or \$24,000 if you are married and gift-splitting is elected) to each of your beneficiaries while you are alive, free of Federal gift tax.

Estate tax is imposed upon the value of the assets you own at the time of your death.

GST tax is imposed on the value of any assets passed on either to grandchildren or to more remote generations during your lifetime or at death. It should be noted that the GST tax is imposed in addition to gift or estate taxes.

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In addition to the annual exclusion mentioned above, gifts of up to \$1 million may be made during your lifetime without incurring Federal gift tax. Similarly, when you die, you may pass on an estate that, when combined with those gifts, equals up to the estate tax exemption amount—the “applicable exclusion amount” as shown in Chart A, without incurring Federal estate taxes. Note also in Chart A that although the applicable exclusion amount increases, the lifetime Federal gift tax exemption remains at \$1 million. Many states impose separate gift and estate taxes on transfers as well, but for purposes of this discussion, we will focus on Federal transfer tax consequences only.

CREATING A GENERATION-SKIPPING TRUST

Generally, you may create a generation-skipping trust during your lifetime or at the time of your death. There are advantages and disadvantages to both options. Retaining the assets while you are alive and creating the trust at death

allows you to enjoy the benefits of the assets during your lifetime, whereas placing them in trust will deny you those benefits.

On the other hand, the million dollars you place in trust now may grow to be substantially more at the time of your death. Importantly, if you select this option, both the million dollars placed in trust and the appreciation it enjoys during your lifetime, if any, are removed from your estate and thus are not subject to estate taxation.

Taken together, this means that creating the trust while you are living will result in less total tax paid and more assets available to your heirs and beneficiaries.

BENEFITS OF DELAWARE LAW

While most states have a law that limits the length of time assets may remain in trust for the benefit of future generations, the State of Delaware allows trusts to continue indefinitely. This means that most types of assets in the trust will benefit descendants forever without being subject

to transfer taxes. Delaware law also provides that as long as there are no Delaware beneficiaries, there will be no Delaware income tax imposed on the trust income and capital gains tax realized in the trust. In addition, because Delaware law waives the usual requirement that trusts be filed with a court, the confidentiality of a trust created outside your will is preserved. Similarly, trust accountings are not required to be filed with a court, resulting in lower costs in the administration of the trust.

Under Delaware law, if you do not want beneficiaries to be informed, for a period of time, of their interests in a trust that you have created, you may provide such language under the trust agreement. You can create a Delaware trust by naming a Delaware trustee, such as Fiduciary Trust International of Delaware.

FUNDING THE TRUST

Once you create the generation-skipping trust, careful consideration should be given to selecting the property to add to it and the timing of those additions.

CHART A Applicable Exclusion Amount/Estate and GST Tax Exemption and Tax Rates

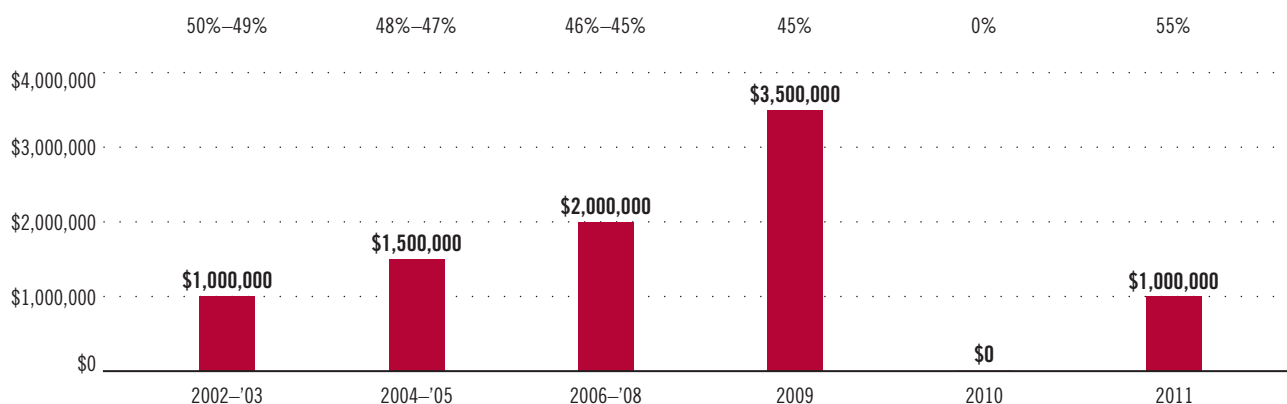
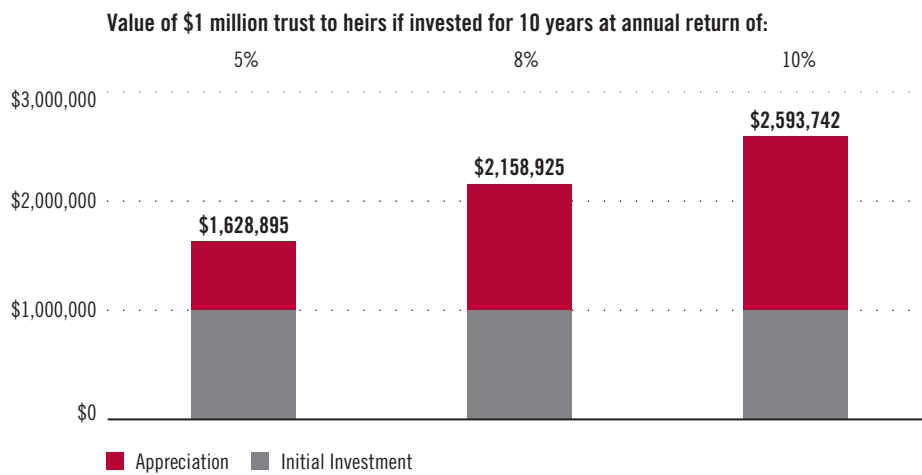


CHART B Gifting the \$1 million GST amount during lifetime protects the appreciation from tax



Low cost basis property

There are disadvantages to funding the trust with property that has a low tax cost basis. Doing so results in that property's basis remaining low after the gift is made, and foregoing the opportunity for that property to acquire a new cost basis at death, equal to its then fair market value. Your legal and financial advisors should be consulted in selecting assets to maximize any valuation discount available to you, or to identify property that can be expected to appreciate.

Multiple-year funding

If you do not fund the generation-skipping trust entirely in one year, you should consider funding over several years to further minimize transfer taxes. This may be possible, if the generation-skipping trust is structured to take advantage of your \$12,000 (or \$24,000) per year per beneficiary gift tax exclusion. Under certain circumstances, it may be advisable to make taxable gifts during your lifetime. However,

you must live at least three years after making a taxable gift in order for the gift tax you pay to escape estate taxation.

INVESTING THE TRUST

Because a generation-skipping trust is designed for multiple generations, the trust's investment objective, presumably, would be long-term growth. The appropriate level of growth to seek (and the accompanying level of risk) depends largely on how this trust fits into your family's total financial picture. If the trust represents a relatively small portion of your family's future wealth, growth objectives can be set fairly aggressively. If, however, the trust represents a more substantial portion, a more conservative growth and risk profile might be appropriate. The benefits of pursuing more aggressive investment goals are illustrated in Chart B.

Under Delaware's Total Return Unitrust Statute and Trustee's Power to Adjust Statute, both the income needs of current

beneficiaries and the asset growth expectations of future beneficiaries can be met.

Under Delaware law, trustees can convert "income only" trusts to unitrust payout arrangements—without court involvement. That is, Delaware trustees now can elect to change the terms of a trust, upon consent of all beneficiaries, to pay out a specific percentage of trust assets (no less than 3% and no greater than 5%) to current income beneficiaries.

Another option under Delaware law to provide trustees with flexibility in defining the income of a trust is the power to adjust. This allows the trustees to increase or decrease the trust income by allocating principal to income, or vice versa, in amounts determined each year.

These laws mean that trustees can invest in assets providing long-term growth, while at the same time, insuring that the income needs of current beneficiaries are fulfilled. A good financial plan will take your family's financial future into account—setting appropriate investment objectives and creating a plan to achieve those objectives at a minimum level of risk.

CONCLUSION

A properly structured, funded and invested generation-skipping trust can be a powerful tool in achieving significant transfer tax savings across generations. Your lawyer or professional advisor is the best person to determine if it is an appropriate tool for your family. Your advisors should also be consulted in determining when to establish and how to structure the trust to achieve optimal transfer tax results.

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Fiduciary Trust's investment management services were extended to foundations and endowments during the 1930s and then to other institutions. In the early 1960s, Fiduciary Trust began investing internationally, making it one of the first American firms to develop global investment capabilities. Fiduciary Trust, an affiliate of Franklin Templeton Investments, offers the following services to clients throughout the world:

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- Manager Selection and Oversight
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This article and other information on wealth management can be found on Fiduciary Trust's website at www.ftci.com.

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