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Irrevocable Dynasty Trusts Utilize $5 Million Exemptions for Gift, Estate and Generation Skipping Transfer Taxes

Summary: As of January 2013, the lifetime federal gift and estate tax exemption and the generation-skipping transfer tax (GSTT) exemption are both set at historically high values of $5.25 million. These exemptions provide an opportunity to individual United States taxpayers to move millions of dollars into an irrevocable dynasty trust without incurring punitive gift taxes, and to ensure that future generations of trust beneficiaries receive benefits free of GST taxes.

At least for the time being, the U.S. Congress has set the unified, lifetime federal gift and estate tax exemption at $5.25 million, with small annual increases expected after 2013. The federal lifetime exemption for the generation-skipping transfer tax (GSTT) is also $5.25 million in 2013. These are the highest exemption amounts in decades. Also, in 2013, the estate and GST tax rates increased from 35 percent to 40 percent. Given projected political and fiscal conditions, it is uncertain how long the exemptions for estate, gift and GST taxes will remain at current, relatively favorable levels.

The historically high exemptions enable individual United States taxpayers to move millions of dollars into an irrevocable dynasty trust without incurring punitive gift taxes, and to ensure that future generations of trust beneficiaries receive benefits free of GST taxes.

An irrevocable trust can be funded with cash, real estate, stocks, bonds, hedge fund interests and virtually any other type of valuable asset. An irrevocable trust can own (and manage) any type of property, including a family business, life insurance and variable annuity policies, and other investment vehicles. When an individual trust grantor (settlor) donates particular property to an irrevocable trust, he gives up formal control over the property. In return, the grantor is able to dictate to a large extent how the trust assets are managed and used, now and in the future, to accomplish his immediate and long-term goals. In other words, the grantor surrenders some degree of control during his lifetime in return for a large degree of future control. Further, assets in the trust are protected against personal creditors of both grantor and beneficiaries.

Finally, an irrevocable trust funded with assets to which gift tax and GST tax exemptions have been allocated allows an individual to build a legacy that passes to his children and which future generations can enjoy and enhance. The unfortunate but inevitable alternative for assets outside of a trust is to be eviscerated by punitive and predatory estate taxes, which force descendents to cannibalize the family business or other legacy at each generation and to pay taxes over and over again.

Not all assets are well-suited for donating to an irrevocable trust. For example, a personal residence owned by a trust but inhabited by the grantor might be viewed by tax authorities as an incompleted gift and, therefore, still within the grantor’s estate. On the other hand, home equity could be turned into cash, which could then be gifted to an irrevocable trust.

Of course, estate and GST taxes can be avoided using other useful techniques. For example, interests in a family limited partnership (FLP) or family limited liability company (FLLC) can be transferred to succeeding generations by simply gifting the assets to family members. Valuation discounting of family business interests can lower exposure to gift taxes. Under circumstances, a personal residence can be efficiently transferred using a qualified personal residence trust (QPRT). These other techniques, however, do not offer the asset protection and long-term wealth preservation and management possible with an irrevocable dynasty trust.

In view of the uncertainty in tax laws and the erratic nature of lawmakers in the United States, any individual having assets totaling more than $1 million should fund an irrevocable dynasty trust to take advantage of the current $5 million gift and GST tax exemptions. Even individuals having $1 million or less should consider placing high-growth assets in a dynasty trust, where they can grow insulated against creditors and against future estate taxes.