INSIGHT ON ESTATE PLANNING

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Create a trust that can span the ages

Do you want to leave a legacy for your family? Besides passing along prized heirlooms, you can arrange a long-lasting transfer of wealth through multiple generations by using a dynasty trust. Not only can such a trust avoid tax, it may provide various other benefits and protections for families for an extended period of time — perhaps forever.

A brief history lesson

The roots of dynasty trusts can be traced back to the common law principle known as the "rule against perpetuities." This rule prohibited trusts from lasting indefinitely and was incorporated into law in most states. Typically, state law would require a trust to end within 21 years of the death of the last potential beneficiary at the trust's creation.

However, some states, such as California, have adopted a simplified version that limits the trust's duration to 90 years. And even better, more than half the states have lifted restraints on trust durations, paving the way for the increased use of dynasty trusts. And a handful of states — including Delaware, Alaska and Florida — encourage outsiders to set up dynasty trusts in their jurisdiction.

The complete tax story

Previously, dynasty trusts were primarily used to minimize transfer tax between generations. Without one, if a family patriarch or matriarch leaves assets to adult children, the bequest is subject to federal estate tax at the time of the initial transfer to the second generation, and then taxed again when the assets pass from the children to the grandchildren, and so on. Although the federal gift and estate tax exemption can shield the bulk of assets from tax for most families, the top federal estate tax rate on the excess is 40% — a hefty amount.

Furthermore, the generation-skipping transfer (GST) tax applies to certain transfers made to grandchildren, thereby discouraging transfers that skip a generation. The GST tax exemption

Dynasty trust Q&A

Here are the answers to some common questions regarding dynasty trusts:

How do you set up a dynasty trust? It can be established during your lifetime, as an inter vivos trust, or part of your will as a testamentary trust. With an inter vivos transfer, you'll avoid estate tax on any appreciation in value from the time of the transfer until your death. Generally, though, with an inter vivos transfer the assets won't be eligible for step-up in basis at your death.

What assets should you transfer to the trust? Because the emphasis is on protecting appreciated property, consider funding the trust with securities, real estate, life insurance policies and business interests. Naturally, you should retain enough assets in your personal accounts to continue to enjoy your lifestyle.

Who should act as trustee? While it may seem natural to choose a succession of family members to act as trustee, that may not be the best route. Instead, consider a professional trustee, often referred to as a fiduciary.

and 40% GST tax rate are the same as they are for regular gift and estate tax.

With a dynasty trust, assets are taxed just once, when they're initially transferred to the trust. There's no estate or GST tax due on any subsequent appreciation in value. This can save some families millions of tax dollars over the trust's duration.

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When the assets are subsequently sold, any gain will be taxable. Note that the basis of the assets will be determined at the time of the initial transfer, although depending on the circumstances, the "step-up in basis" rules may help to reduce the taxable amount.

Other benefits

Regardless of the tax implications, there are many nontax reasons for wealthy individuals to set up a dynasty trust. For example, you can designate the trust's beneficiaries spanning multiple generations. Typically, you might provide for the assets to follow a line of descendants, such as your children, grandchildren, great-grandchildren, etc. You can also impose certain restrictions, for example, limiting access to funds until a beneficiary graduates from college.

Look before you leap

A dynasty trust creates a legacy that will live on long after you're gone. Be aware, however, that a dynasty trust is irrevocable. In other words, you can't undo the arrangement if you have a sudden change of heart. If you're going to chart the course for future generations, you must have the courage of your convictions. Rely on your estate planning advisor for guidance. •

Overlooking foreign assets can be detrimental to an estate plan

When working with an estate planning advisor, it's critical to disclose all your assets. Importantly, any foreign assets you might have must be included.

Often, people assume that these assets aren't relevant to their "U.S." estate plans, so they're not worth mentioning. However, your advisor can help structure ownership of any foreign assets according to the laws of the United States and the country where they're located. Here are some questions to consider if you own foreign assets.

Can I avoid being taxed twice?

If you're a U.S. citizen, you're subject to federal gift and estate taxes on all your worldwide assets, regardless of where you live or where your assets are located. So, if you own assets in other countries, there's a risk of double taxation if the assets are subject to estate, inheritance or other death taxes in those countries. You may be entitled to a foreign death tax credit against your U.S. gift or estate tax liability — particularly in countries that have tax treaties with the United States — but in some cases those credits aren't available.

Keep in mind that you're considered a U.S. citizen if:

1) You were born here, even if your parents have never been U.S. citizens and regardless of where you currently reside, unless you've renounced your citizenship, or

2) You were born outside the United States but at least one of your parents was a U.S. citizen at the time.

Even if you're not a U.S. citizen, you may be subject to U.S. gift and estate taxes on your worldwide assets if you're domiciled in the United States. Domicile is a somewhat subjective concept — essentially it means you reside in a place with an intent to stay indefinitely and to always return when you're away. Once the United States becomes your domicile, its gift and estate taxes apply to your assets outside the United States, even if you leave the country, unless you take steps to change your domicile.

Now that the federal gift and estate tax exemption is $12.92 million for 2023, you may not be concerned about U.S. gift and estate taxes. But remember, the exemption amount is scheduled to revert to its pre-2018 levels of $5 million (indexed for inflation) as of the beginning of 2026.

Even if your estate is well within the current exemption amount, it's a good idea to plan for a potential estate tax bill down the road. Further, for married couples, the rules are different — and potentially a lot more complex — if one spouse is neither a U.S. citizen nor considered a resident for estate tax purposes.

Are separate wills required?

To ensure that your foreign assets are distributed according to your wishes, your will must be drafted and executed in a manner that will be accepted in the United States as well as in the country or countries where the assets are located. Often, it's possible to prepare a single will that meets the requirements of each jurisdiction, but it may be preferable to have separate wills for foreign assets. One advantage of doing so is that separate wills, written in the foreign country's language (if not English) can help streamline the probate process.

If you prepare two or more wills, it's important to work with local counsel in each foreign jurisdiction to ensure that the wills meet each country's requirements. And it's critical for your U.S. and foreign advisors to coordinate their efforts to ensure that one will doesn't nullify the others.

Will my nationality affect my plan?

If you're a foreign citizen living in the United States, estate planning can be complicated. One source of confusion is the difference between residency and domicile. If you're a U.S. resident — which is based on the amount of time you spend in the United States — you're subject to U.S. income taxes on your worldwide income. But resident aliens aren't subject to U.S. gift and estate taxes unless they're domiciled in the United States. You can be a resident without being a domiciliary, although residency is a factor in determining domicile.

If you're not a U.S. citizen or domiciliary — that is, if you're a resident alien who's not domiciled in the United States, or you're a nonresident alien — then U.S. gift and estate taxes will not reach your assets outside the United States. However, you'll be subject to those taxes on assets that are "situated" in the United States, including real estate and certain investments in U.S. businesses. And unlike the $12.92 million (for 2023) allowed to U.S. citizens and domiciliaries, the estate tax exemption amount is a paltry $60,000.

Disclose and plan for specific assets

The bottom line: If you own foreign assets, disclose and account for them in your estate plan. Your advisor can help you structure ownership of these assets in accordance with the laws of the United States and the country where they're located. •

Going through a divorce?

Ease the transfer of retirement plan assets with a QDRO

Despite its unusual sounding name, a QDRO isn't an alien from a science fiction movie or a geometric equation. In fact, QDRO stands for "qualified domestic relations order." If you're in the process of a divorce, a QDRO may provide for the transfer of assets in a qualified retirement plan to a nonparticipant spouse without incurring dire tax consequences.

Asset transfer complications

Getting divorced and dividing up assets is no easy matter. At least you can sell a house or car or certain other possessions and distribute the proceeds according to the ownership rights under law. But liquidating other types of property, such as assets in a qualified retirement plan, can be more complicated.

To add to the complexity, you must take taxes into account. Generally, distributions from a qualified plan like a 401(k) plan are subject to federal income tax at ordinary income tax rates, currently topping out at 37%. Furthermore, state income tax may apply to the payouts. And, if you take a plan distribution prior to age 59½, you must pay a 10% penalty on top of the regular income tax bite, unless a special exception applies.

A QDRO in action

This is where a QDRO can come to the rescue. It provides a relatively straightforward means of accommodating a transfer of qualified retirement plan assets.

A court with jurisdiction or another appropriate authority issues the QDRO. Essentially, the QDRO establishes that one spouse has a claim to some of the other spouse's retirement plan accounts. Typically, the QDRO will state either a dollar amount or a percentage of assets that belongs to the spouse of the participant, called the "alternate payee" in legal parlance. It also specifies the number of payments to be made (or the length of time for which the terms apply).

A QDRO may be used for qualified plans covered by the Employee Retirement Income Security Act (ERISA), including 401(k) plans, traditional pension plans and various other plans. In contrast, IRA funds, which aren't covered by ERISA, generally are disbursed according to the terms of the divorce agreement.

With an approved QDRO in place, the alternate payee doesn't owe any penalty tax on distributions. Thus, you can arrange a lump-sum distribution or series of periodic payments penalty-free according to the order, regardless of your age.

A QDRO must provide certain information, including the names and addresses of both the plan participant and the alternate payee; the dollar amount or percentage of assets being transferred to the alternate payee; and other vital details such as the amount, form and frequency of payments. If required information is omitted, a judge won't sign off on the order. Rely on your professional advisor to ensure that all formalities are met.

After a QDRO is approved by the judge, there's still more work to do. The alternate payee must submit it to the administrator of the retirement plan. Every plan governed by ERISA must follow the authorized process for QDRO filings. After the plan administrator accepts the QDRO, it's good to go.

Note that an administrator can take up to 18 months to complete the process. Therefore, the sooner you do the necessary paperwork, the better. Preferably, the QDRO should be finalized before the divorce. If the QDRO is rejected — for example, because it requires a lump-sum distribution and the plan doesn't offer that option — it's back to the negotiating table.

Available payment options

Assuming QDROs are allowed by the plan, the alternate payee will have payment options to consider. For starters, he or she can take a lump-sum distribution of the full amount. However, this may result in a higher overall tax liability than if the payments were spread out. Or, the alternate payee can arrange to receive regular payments just like the plan participant, thereby reducing the total tax hit.

Another option is to roll over the assets into another plan or IRA. If the usual requirements are met — for example, the rollover is completed within 60 days — no current tax is owed for the year of the transfer.

Finally, the alternate payee may leave the money where it is. If permitted by the plan, additional contributions to the account may be made in the future.

Seek professional guidance

Does a QDRO make sense for you? It depends on your situation. Turn to your professional advisor for guidance. •

ESTATE PLANNING PITFALL

You missed the estate tax filing deadline

You likely don't need to be reminded about filing your federal income tax return on time. Indeed, the tax filing deadline date of April 15 (or the next business day if the due date falls on a weekend or holiday) is probably ingrained in your memory. However, if you're the executor of the estate of a loved one, do you know the filing date of an estate tax return?

The due date for filing a federal estate tax return varies. Generally, you must file the return within nine months of the date of death. It's up to you to ensure that this obligation is met.

What happens if you fail to file the return on time? The estate could be hit with interest and penalties on top of any federal estate tax that's due.

Here's a practical solution: File Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. Doing so provides an automatic six-month filing extension with no questions asked by the IRS. With the extension, you should have sufficient time to address any outstanding issues and file the return on time.

But be aware that an extension to file isn't an extension to pay tax. If you request a payment extension, the IRS has discretion for approval or refusal.

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