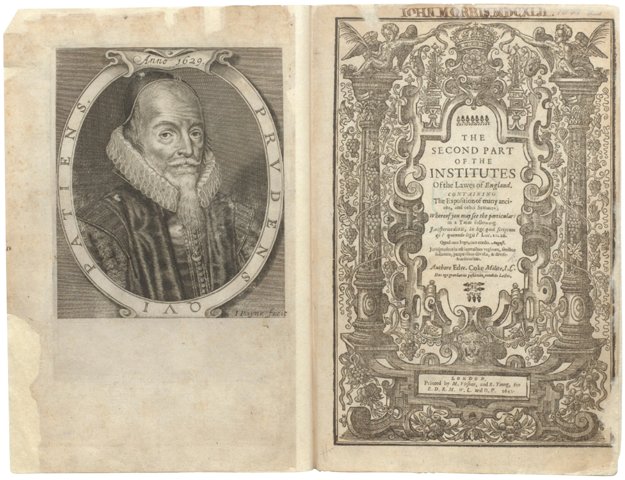
NOVEMBER 2021, ISSUE 13

Dynasty Trusts

Introduction

For a trust to last generations, a deliberate and expertly executed structure must be put in place. One significant consideration is how some states limit the time a trust may be in existence. Once this statutory time limit elapses, a trust terminates and its assets must be distributed outright to the beneficiaries. To sustain and preserve those assets for future generations, the recipient beneficiaries—if they so desire—must put the assets back into trust. This limitation is highly problematic. Not only can the process trigger gift and generation-skipping transfer taxes, it is meticulous and time-consuming. Success depends on the willingness of the beneficiaries to preserve their wealth going forward; their foresight to make thoughtful, informed decisions in the construction of the trust instrument; appropriate Trustee selection; and conservative trust administration.

In the past, the Texas Rule Against Perpetuities ("RAP") limited a trust's duration to about 130 years, a relatively short period of time given the size of many trusts. In response to ongoing complaints from Texans, the legislature recently passed HB654, which extends the RAP period. As of September 1, 2021, trusts with a Texas situs may now last a duration of 300 years, with the exception of real estate assets, which are limited to being in trust for a period of 100 years.

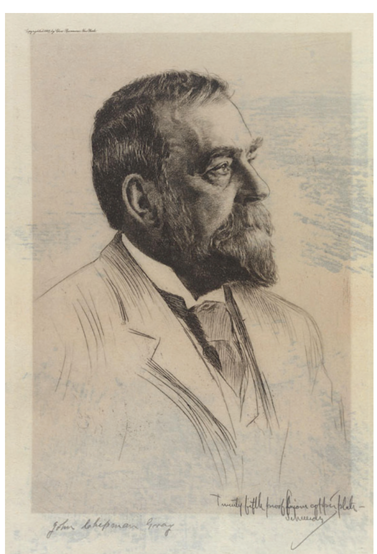


Written in the late 1620s, a pioneering four-volume treatise on English common law.

Historical Context

The Rule Against Perpetuities originated in feudal England as a common law property rule, addressing a problem with the way English estates were often structured. Referred to as the "dead hand," land-rich Englishmen would put their property into trust in perpetuity, allowing future generations to benefit from use of land without ever actually owning it. This structure did allow property to pass intact to successive generations free of estate taxes, but grantors also regularly imposed their unique rule restrictions on property long after death; these often hindered the flexibility of managers and trustees to adapt to changed circumstances and conditions that were impossible for original grantors to anticipate.

Similar problems emerged in the United States, where inheritance followed English common law. To address these problems, in the late 1800s American legal scholar John Chipman Gray developed a model for what would become the modern RAP. The basic concept was to prevent grantors from tying up property in perpetuity by defining an allowable term for certain types of trusts. Gray's model code provided that a trust interest taking effect in the future must do so within a limited duration based on the lifespan of the generation then living, plus an additional period of time, known as the perpetuity period. Gray chose 21 years for the perpetuity period, meaning the testator could only put restrictions on property for the first grantee generation, plus 21 years. If the drafting language for a trust created an interest that fell beyond the perpetuity period, the entire trust, no matter how well drafted otherwise, would be invalid.



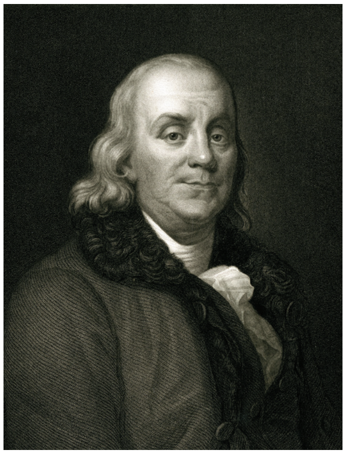
John Chipman Gray (1839-1915)

Many states adopted Gray's code in its entirety. Others passed legislation that rejected the rule outright. Texas adopted Gray's formulation, but excluded charitable trusts, which could remain in effect in perpetuity. Given their often unfavorable effects, RAP statutes were softened in many states so as to merely limit the duration of trusts, rather than invalidate entire estate plans. But despite these revisions, RAP still posed a significant problem for estate planning.

Why RAP Was a Problem

The main effect of RAP was to prevent the creation of dynasty trusts. Dynasty trusts are trusts that exist over many generations. Because assets of the trust are distributed in small parts over many years rather than in one large lump-sum, grantors can avoid substantial taxes on transfers, including gift tax, estate tax, and generation-skipping transfer tax. However, when a trust ends and assets are distributed to beneficiaries, the distributions incur various tax consequences. Oftentimes the recipient beneficiaries eventually place assets back into trust for their descendants, again incurring tax penalties. This process may repeat for each subsequent generation, eroding the value of the original gift each time taxes are incurred.

Prohibiting dynasty trusts also makes it impossible to ensure that future generations will be good stewards of their wealth. With the right restrictions, dynasty trusts can provide many generations of beneficiaries with reasonable support for basic needs such as healthcare and education, while encouraging beneficiaries to earn their own wealth. With trusts of limited duration, however, grantors can only hope that beneficiaries will preserve assets and place them back into trust for their children and grandchildren. This often does not happen because future generations simply do not get around to it or because they spend down the corpus of the trust once it is distributed.



Benjamin Franklin, the American statesman, scientist, and philosopher (1706 – 1790)

Dynasty trusts also allow a trust to grow exponentially through compound interest, affording distributions for current beneficiaries while keeping the corpus of the trust intact and growing. The benefits of compound interest are widely known. While lawmakers were prohibiting the use of dynasty trusts for individual grantors, the United States' Founding Fathers were utilizing very long-lived charitable trusts to harness the power of compound interest to benefit their cities.

For example, one of America's finest innovators, Benjamin Franklin, experimented with charitable dynasty trusts and the idea of compounding interest for beyond his lifetime. When he passed, Franklin's will left each of Boston and Philadelphia a final gift of 1,000 pounds of sterling silver, which at the time was worth around $4,000. The will provided the assets were to be held in trust for 200 years. For the first 100 years, the funds would accrue interest earned on loans to young tradesmen aspiring to start their own businesses. At the end of the first period, in 1890, the cities were to spend 75% of the trust corpus on public works. The remaining 25% of the principal would be invested for an additional 100 years, until 1990, at which time the funds would be disbursed for the cities to use as they best saw fit. When the first round of funds were disbursed to the cities, the Boston fund had increased to approximately $370,000, while the Philadelphia trust was valued at approximately $72,000. When the funds were disbursed in 1990, Boston's fund had grown to $5 million, while Philadelphia's trust was valued at $2.25 million. Benjamin Franklin was able to create new opportunities and a lasting legacy for the cities he loved most dearly, even 200 years after his death. There is no denying that this was an impactful gift that benefitted generations well past Mr. Franklin's own.

Prior to 2021, Texas' RAP essentially limited trusts to around 130 years. This limitation caused many wealthy Texas residents to find alternate situs for their trusts, choosing states that allowed longer durations. Texas was one of the few states still following the RAP as it was originally written with the 21-year vesting period. As a result, many assets were moved outside of Texas, benefitting businesses surrounding trust administration, tax preparation, and investment management in those states rather than Texas. With favorable trust laws in other states, the trusts could be created in other states such as Delaware, South Dakota, Wyoming, and Nevada, and remain there for generations. A study by Yale Law Journal found that approximately $100 billion in trust assets moved to states where the RAP statute had been amended or dissolved.[1]

A Texas-Sized Solution

In response to the above problems, the state finally passed legislation that significantly extended the perpetuity period for personal property, such as investment funds, securities, and bonds, to 300 years. The change passed in 2021 after nine failed attempts over 20 years, taking so long because legislators were concerned with tying up real property for long lengths of time, even though assets were leaving the state. The final version of the bill limited real property in trust to 100 years. This limit on real property in trust is due to a populist strain in Texas. Those in support of the restriction believe that real estate should not be held by one line of descendants for hundreds of years without becoming open to creditors, spouses, and anyone who might have a claim to the property once no longer tied up in trust.

[1] Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 Yale Law Journal 356, 359 (2005).

A Texas grantor can now impact many more future generations according to the grantor's wishes. Given that Texas does not impose an income tax on trusts and allows for directed trusts and for the decanting of trusts, it was already a favorable trust situs. Extending the RAP removes the last major barrier to keeping trust situs in Texas.

The change will also benefit the State of Texas. The Texas Bankers Association reported that the revision to Texas' RAP will cause an inflow of an additional $6 billion of trust assets managed in Texas, generating approximately $60 million in management fees for Texas companies. This revenue number does not include professional accounting and estate planning fees that Texas trusts will generate.

Conclusion

With this extended term for Texas dynasty trusts, grantors should carefully consider the drafting and administration of their trusts. Without expert planning and management, the allowable duration becomes irrelevant. Instead, poor investment performance, wasting of assets, and excessive spending are the biggest threats to a trust's duration.

Large 300-year trusts affecting many generations brings additional considerations for the grantor. Through only four generations, a family that began with four members can quickly grow to be a family of over 20 members, with each member serving as a beneficiary of the same trust (see illustration in Appendix A). To ensure that all beneficiaries are adequately provided for, grantors can limit beneficiary qualifications, distribution standards, or allowable distribution amounts to narrow to whom and for what purposes trust assets can be distributed. For example, some families choose to establish education or medical trusts, where funds can only be distributed for those purposes. Others choose only to provide for beneficiaries who are in their retirement-aged years or working full-time jobs. Each family is unique, having its own values and priorities for funding.

It is important to note that some legal minds question whether the new RAP duration is permissible under the Texas Constitution.[2] For this reason, many estate planning attorneys are drafting trusts to comply with the new RAP but include an alternative vesting period in the event that Section 112.036 of the Texas Property Code be modified further. This alternative provision is important because if a trust violates the RAP, the trust may be void with the property interest reverting to the grantor.

At Houston Trust Company, we welcome trusts drafted to take advantage of the new law, while providing for alternatives should the rule be modified. Through conservative, prudent, and thoughtful administration, investing, and advising of beneficiaries, a trust can be well equipped to stand the test of time, benefitting generations long into the future.

[2] "Perpetuities and monopolies are contrary to the genius of a free government, and shall never be allowed, nor shall the law of primogeniture or entailments ever be in force in this State." (Texas Constitution, Article 1, Section 26).

Appendix A

The timeline below illustrates the possible beginning years of a dynasty trust and assumes that the trust is invested in the equities market with favorable market conditions.

KEY	
GC -	GRANDCHILD
GGC -	GREAT GRANDCHILD

GENERATION 1

2021

Grantors create a $20 million trust for the benefit of their descendents, per stirpes.

The trust is for the benefit of the descendents health, education, maintenance, and support.

GENERATION 2

2032 - 11 years after trust creation

Distributions totaling $500,000 have been made to the children each year for the past 11 years. The trust's value is now $32 million due to a strong investment strategy. Each child now has two children.

GENERATION 3

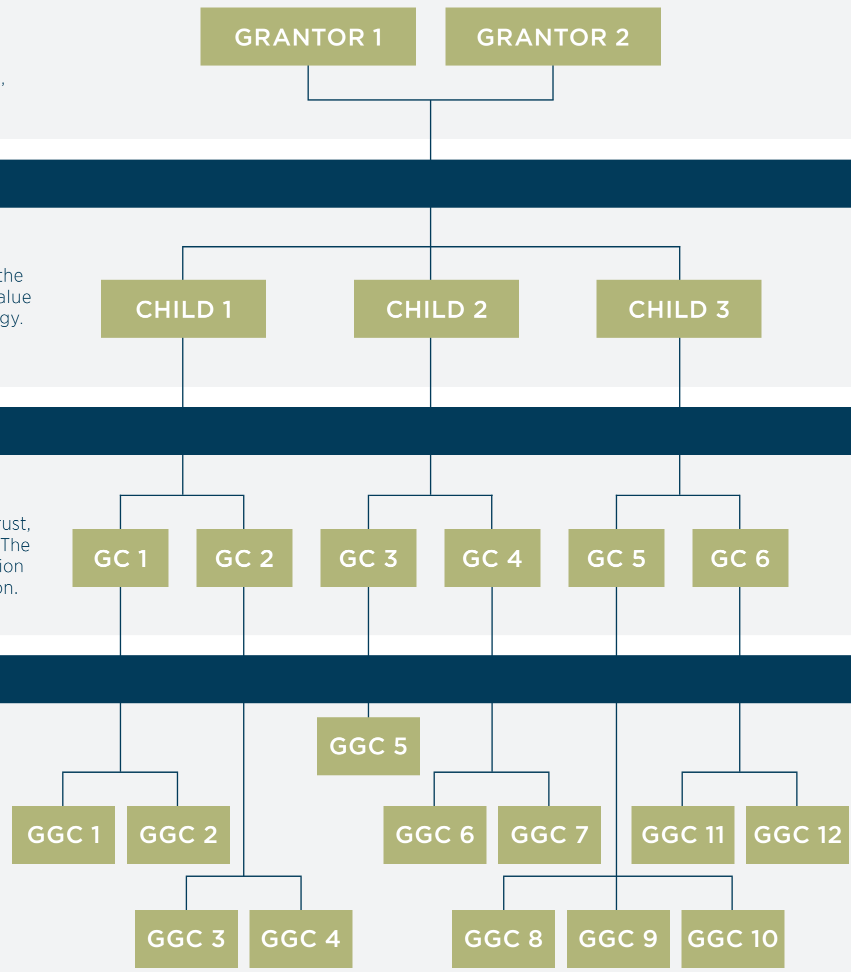
2046 - 25 years after trust creation

The grandchildren, who are also beneficiaries of the trust, all go through private school and some go to college. The distributions have increased to approximately $1 million per year. The trusts' value has increased to $54 million.

GENERATION 4

2053 - 32 years after trust creation

The trust has been in existence for over 30 years. The value is now $74 million. Some grandchildren have children. At this point, there are 13 beneficiaries of the trust. While the trust's assets grow, the number of beneficiaries entitled to the trust also grows. In order to remain conservative and to maintain the assets and corpus of the trust for future generations, the trustees have determined that distributions cannot exceed $1.5 million per year.



Points to Consider While Planning For a Dynasty Trust

Based on the illustration above, let's assume that it's 2060 (32 years after the trust was created) and the following situations are true:

- Generation 1 is deceased.
- Generation 2 needs full-time caretakers.
- Generation 3 is in fair health but has major home repair needs.
- Generation 4 is in private grade school and will be going to college soon.
- The goal is for the trust to last 258 more years and several more generations of descendants.

While it is impossible to predict the exact circumstances of a family four generations down the road, consider how you might answer the following questions:

1.) To maintain the trust, the trustees have determined only $2 million can be distributed from the trust each year. How should the funds be allocated and whose needs should take priority?

2.) Should the beneficiaries be allowed a power of appointment in their wills? If so, what impact will that have on the future beneficiaries?

ABOUT THE AUTHORS

Kahler Biedenharn Marlow
Vice President, Trust Administration

Kahler Biedenharn Marlow joined Houston Trust Company in 2019. As Vice President of Trust Administration, she is responsible for personal trust administration, client service, and special asset support. Prior to joining Houston Trust Company, Kahler was a Trust Administrator with Frost Bank.

Kahler earned a Bachelor of Arts degree in International Relations and Global Studies from the University of Texas at Austin and a Doctor of Jurisprudence degree from South Texas College of Law. Kahler is a member of the Houston Estate and Financial Forum, the State Bar of Texas, Houston Young Lawyers Association, Houston Bar Association, the Junior League of Houston. She currently serves as the chair of the Houston chapter of Stewards of the Wild and as co-chair of the Advisory Board for Kids Meals Inc.

David Rice Lummis
President and CEO

David Rice Lummis is a co-founder of Houston Trust Company. He currently serves as President and CEO and the Company's Chief Investment Officer. For seven years prior to the formation of the Houston Trust Company, he oversaw stock and bond portfolios, operating businesses, real estate, litigation support, and estate planning for a large Houston family office. He was also involved for several years as a Representative in concluding the Howard Hughes estate administration. His investment management and capital markets experience includes four years as an investment banker in corporate finance and mergers and acquisitions with Lazard in New York.

A native Houstonian, David holds a Bachelor of Arts from Princeton University and Masters of Business Administration and Masters of Accountancy degrees from Rice University.