Special Use Trusts

The Dynasty Trust: Protective Armor For Generations To Come

An important truth in estate planning is that property held in trust is generally more beneficial than property held outright

By **PIERCE H. McDOWELL, III**
Norwest Bank, South Dakota
Sioux Falls, SD

Editor's note: The author gratefully acknowledges the assistance of David A. Herpe and Paul J. Collins, of Schiff, Hardin & Waite, Chicago, IL, and New York, NY, in the preparation of this article. Special appreciation to Roy M. Adams for his unwavering support and friendship.

A curious phenomenon to those of us who follow such matters is that many of the trusts created by wealthy families in the latter part of the last century or the early years of this century, are now terminating. A news account of the recent sale of the Boston Globe, for example, noted that the sale was prompted by the impending expiration of family trusts that owned the newspaper and that had allowed control to remain in the same family since 1872. Another interesting case was provided by Lucius P. Ordway of St. Paul, MN, an early investor in Minnesota Mining & Manufacturing (3M), who created a family trust in 1917. The trust terminated in 1979 when the last of Ordway's five children died, and the trust funds were distributed to his grandchildren, one of whom filed a disclaimer of her share, prompting a long-running dispute with the Internal Revenue Service that the United States Supreme Court this past June agreed to hear. Another example, not stretching quite as far back in time, is provided by William Randolph Hearst, who in his 125-page Will created a family trust to own one-third of the stock of Hearst Corp. That trust will expire with the death of the last of Hearst's eight grandchildren alive when he died in 1951, an event estimated to occur around the year 2035. Cases such as these raise a question that is more than a mere curiosity for estate planners, namely, what if a trust could be created to last forever?

The Dynasty Trust Concept

The basic premise underlying the federal transfer tax system is that property is to be taxed each time it passes from one generation to the next. Thus, transfers made either during an individual's lifetime or at his death to his children will be subject to transfer tax. In the same manner, the property which the children have received from their parents will, unless it is consumed by them during their lifetimes, again be subject to tax when they transfer it to their own children. The result, from the perspective of a grandfather who wishes to pass his property down to his grandchildren, is that property will be taxed twice before this process is completed.

This scheme of taxation was successfully avoided in many instances by wealthy families who placed their wealth in trusts, so that no estate tax was incurred on the death of an individual whose only interest in the trust was a life estate. To reduce or eliminate the use of trusts as estate tax avoidance devices, Congress enacted the Federal Generation Skipping Transfer Tax (the "GST Tax"). In its current form, the GST Tax imposes a tax at the highest marginal estate tax level on certain "generation-skipping transfers." Such transfers can include a "direct skip" from a grandparent to a grandchild or "taxable terminations" or "taxable distributions" from trusts to persons who are "skip persons" with respect to the transferor of the trust property (that is, occupy a generation at least two removed from the transferor).

Congress has granted limited relief from the GST tax in Code Sec. 2632(a), which provides for an exemption from the GST tax in the amount of $1,000,000 per individual. This exemption allows affluent persons to use, albeit to a lesser extent, the same strategy used by the Rockefellers and the Vanderbilts for generations to avoid estate tax. The technique commonly used for this purpose is an irrevocable perpetuities trust — also called a "dynasty trust" — for the benefit of a settlor's descendants. In the typical case, the trustee will be given discretion as to whether income or principal should be distributed. It is usually anticipated that only limited distributions will be made, so that trust principal will be preserved for future generations.

The dynasty trust is funded with property to which the settlor allocates all or a portion of his or her GST exemption. The settlor's spouse may take part in the funding of the trust, allowing a total GST exemption of $2,000,000 to be allocated to the trust. Once exempted, the property transferred to the trust, as well as any appreciation on the property and all accumulated income from the property, will remain forever free from federal transfer taxation — but only for as long as the property remains in the trust, typically for as long as the rule against perpetuities allows.

The rule against perpetuities provides that a trust may not postpone the vesting of interests beyond a certain period, which is usually defined as 21 years after the death of the last to die of certain identified lives in being at the time the trust was created. A vested interest is one which gives the beneficiary ownership and possession of the trust assets and requires termination of the trust, either immediately or at some specified future time. Once the trust property vests in a beneficiary, transfer tax will occur at that beneficiary's generation level — at rates as high as 50 percent under current federal law (scheduled to return to 55 percent under pending legislation)[1] — and this will drastically reduce the amount of property that remains for future generations.

A dynasty trust may be created either during the settlor's lifetime or at his death. If lifetime funding is used, there can be more property held in the trust by the time the settlor dies than could have been placed there if the initial trust funding occurred at the settlor's death. Lifetime funding of the dynasty trust also has the advantages of locking in the benefit of the current $600,000 unified credit exemption equivalent for gift and estate tax purposes, which may be reduced in the future (although last year's proposal in this regard did not become law), and removing the gift tax funds from the settlor's estate. The settlor may be reluctant to fund her dynasty trust fully during her lifetime, since to do so will involve the payment of gift tax. Often the trust will be funded only to the extent of the available exemption equivalent — $600,000 for an individual settlor or $1.2 million for a married settlor whose spouse agrees to split the gift. Sufficient property to absorb the balance of the $1,000,000 GST exemption amount is then transferred to the trust at the settlor's or the spouse's death.

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The growth of assets within a dynasty trust can be likened to the French riddle of the lily pad. On the first day there is just one lily pad in the pond. The next day the lily pad doubles. Thereafter each of its descendants doubles. In 30 days, the pond completely fills with lily pads. When is the pond exactly half full? Answer: On the 29th day. Unfortunately, just when the dynasty trust dollars are about to achieve their greatest proliferation — in the trust's "29th day" — the trust normally must terminate, exposing the dollars to confiscatory transfer taxes, all because of the rule against perpetuities.

The Truly Perpetual Trust

The rule against perpetuities exists in some variant in virtually all states. In these states the term "dynasty trust" is something of a misnomer, since the trust will in fact end when the perpetuities period expires. A few states — Idaho, South Dakota and Wisconsin — have no rule against perpetuities. If a dynasty trust is established in one of these states, the trust can in theory last forever. As long as the trust continues, the trust assets will be exempt from federal transfer taxation due to the GST exemption that was allocated to the trust when it was created.

This article will consider South Dakota as the model situs for a dynasty trust. It is the author's view that a South Dakota dynasty trust is preferable to one established in any other state. In addition to the advantage of having no rule against perpetuities, South Dakota also has no state income tax and, moreover, offers a very favorable business climate. (The latter factor is one of the reasons why a recent Money magazine article named Sioux Falls, South Dakota, as the best place to live in the United States.) It is possible, though, that favorable results may be obtained in the other jurisdictions mentioned, and their laws will be mentioned briefly.

Applicable Statutes

South Dakota repealed its rule against perpetuities in 1989. South Dakota does have a rule against suspension of the power of alienation. S.D. Cod. L. Sec. 43-5-1. This statute provides that the power of alienation may not be suspended for a period longer than the continuance of the lives of persons in being plus 30 years. The statute also provides, though, that while the suspension of the power to alienate trust property is within the ambit of the statute, a violation of the rule is avoided if the trustee has the power to sell, or if there is an unlimited power to terminate in one or more persons in being. S.D. Cod. L. Sec. 43-5-4.

As long as the settlor of the South Dakota Dynasty Trust grants the trustee the power to sell trust assets, the trust's existence will not be limited by the rule against suspension of the power of alienation. The power of sale does not mean that the trustee is required to distribute the sale proceeds to the beneficiaries, or even to sell the trust assets at all.

Another pertinent South Dakota statute provides that, while the income from real estate may be accumulated for a beneficiary under age 21, such accumulation must terminate when the beneficiary reaches age 21. S.D. Cod L. Secs. 43-6-4 through 43-6-6. Ordinarily the terms of a dynasty trust will require, or at least authorize, the accumulation of trust income. Thus, it would be necessary to fund the South Dakota Dynasty Trust with assets other than real estate in order to avoid the effect of this statute. Alternatively, the trust instrument could contain provisions reminding the trustee of the existence of the statute and providing guidance for the trustee based on the settlor's wishes. The trust might, for example, require that no real estate be held by the trust unless the income from it will be paid out.

Case Study Comparison

Presented below is a case study comparing the results achieved by three identical dynasty trusts established in South Dakota, Illinois and New York. Illinois and New York were selected as the comparative states because they represent low-income-tax (Illinois) and high-income-tax (New York) states. The case study is based on the following facts:

> Assume that in 1993, a 70-year-old Settlor establishes a Dynasty Trust by lifetime gift for the benefit of his descendants with $1,000,000 of cash and exempts the entire trust with his GST exemption. It is his intention that the trust last for the longest possible time permitted by law. At the time the trust is created, he has a 45-year-old child and a 20-year-old grandchild living. Under mortality tables used by the Internal Revenue Service, the grandchild has a life expectancy of about 62 years. Therefore, in a state where the rule against perpetuities applies to the trust, the longest expected period of time that vesting of the trust can be postponed, assuming the grandchild is the youngest identifiable life when the trust is created and he lives to his life expectancy, is 83 years (62 + 21). Assume further that at the end of the 83 years, there will be a great-grandchild living in whom the trust will vest, and that the great-grandchild will die two years later (i.e., in the 85th year after creating the trust). Finally, assume that the cash will be invested in marketable assets that will earn a 5 percent current yield over the trust term, that trust assets will appreciate at the rate of 7 percent annually over the term, and that the trust portfolio "turns over" (is sold and reinvested) at a rate of 20 percent annually.

The critical question is: What will each dynasty trust be worth, and hence what amount of property will each make available to the family, following the great-grandchild's death in Year 85? In either Illinois or New York the trust must vest in the great-grandchild at the end of the 83-year term. As a result, the trust property will be subject to gift or estate tax at the generation level of the great-grandchild before it passes to the next generation. In contrast, because the South Dakota trust can postpone vesting indefinitely beyond the 85th year, no vesting in the great-grandchild is required. Therefore, no transfer taxation at that generation level will occur.

Based on the facts described above, the performance of the South Dakota trust by the end of the 85-year period, compared to the performance of the other two trusts, is as follows:

After-tax Income Generated:

South Dakota:	$1.4 billion
Illinois:	$1.3 billion
New York:	$871 million

Appreciation In Trust Assets:

South Dakota:	$1.0 billion
Illinois:	$934 million
New York:	$622 million

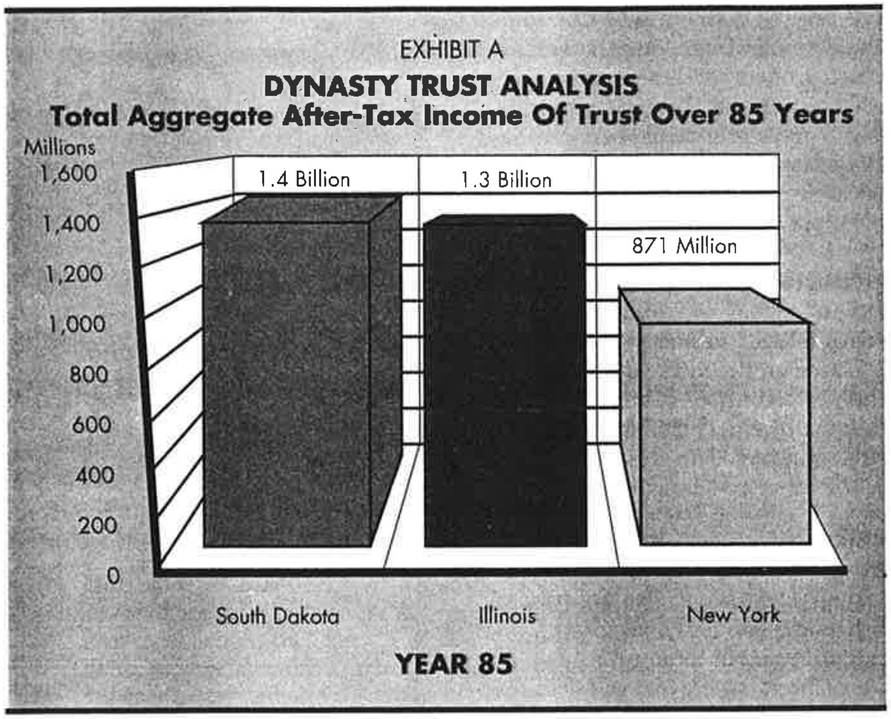
Value Available to Family:

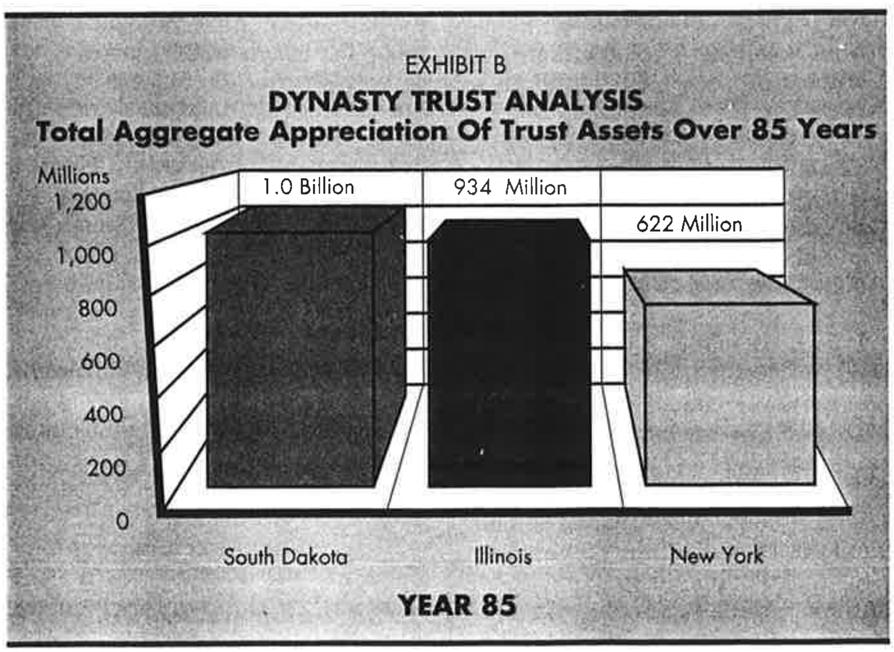
South Dakota:	$1.9 billion
Illinois:	$777 million
New York:	$488 million

It can be seen that the South Dakota trust will provide over 240 percent more value than the Illinois trust and almost 390 percent more value than the New York trust. Why does the South Dakota trust produce so much more overall value to the family at the end of the 85-year period — $1.9 billion compared to $777 million for the runner-up Illinois trust? The answer is its avoidance of the devastating federal transfer tax. The South Dakota trust, unlike the Illinois and New York trusts, need not terminate and expose its assets to such tax after 83 years.

Exhibits A, B and C illustrate graphically the comparative results just discussed. This comparison is based on the assumption that all trust income is accumulated and no principal invasions occur over the illustrated term. Total accumulation and retention is not required for a dynasty trust; discretionary invasion provisions for family beneficiaries are commonly used. While total accumulation is unrealistic to expect for most dynasty trusts, the relative advantages of the South Dakota trust over the same trust created in another state should remain about the same even if discretionary income and principal distributions are assumed, so long as some degree of accumulation or appreciation occurs.

The benefits of the South Dakota trust will not end after the 85-year period assumed in the example. Because the South Dakota trust *need never terminate*, the benefits will continue to compound over future generations. It is easy to imagine that the relative benefit of the South Dakota Dynasty Trust over a couple of hundred years could reach into the multiple billions of dollars.





No South Dakota Income Tax

Another advantage to South Dakota situs for a dynasty trust is that there is no state income tax in South Dakota. Indeed, in the November 1992 election an initiative to impose a state income tax was resoundingly defeated. The lack of a state income tax distinguishes South Dakota from the two other states that have no rule against perpetuities — Wisconsin and Idaho.

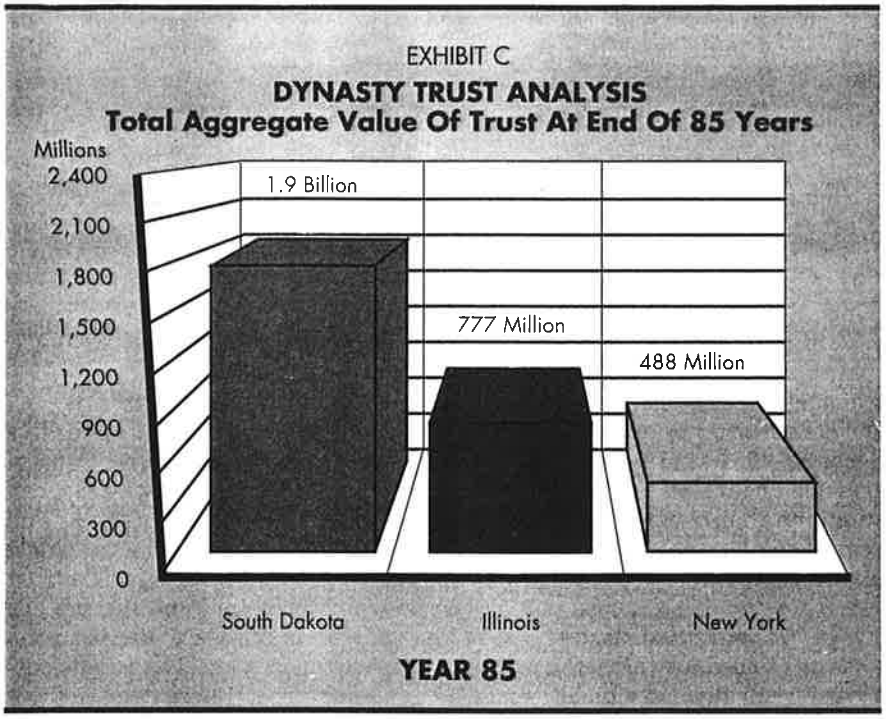
In the case of a non-resident settlor or non-resident beneficiaries, if income taxation in the domiciliary state can be avoided, locating the trust in South Dakota can produce a more favorable income tax result, at least as long as income and gains are accumulated in the trust. If the grantor had an asset which had substantially appreciated in value and which was to be sold, the asset could be contributed to the South Dakota trust, and the trust could then sell the asset without any state income tax on the gain, thus preserving principal.

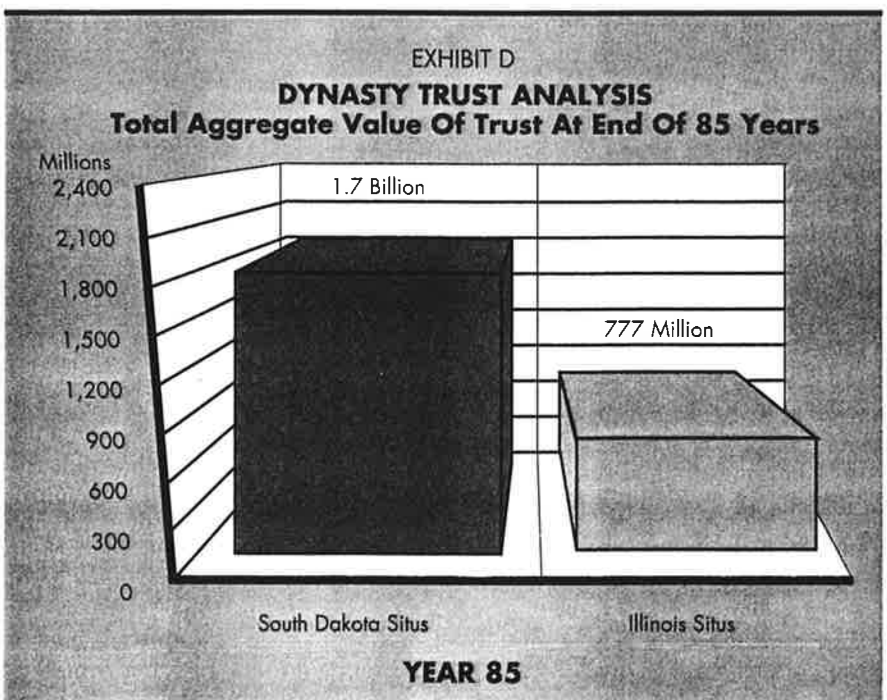
It is possible that a South Dakota Dynasty Trust may be characterized by the taxing authorities as a "resident trust" for income tax purposes in the state where either the settlor or the beneficiaries reside. Because South Dakota has no income tax of its own, however, no additional tax burden is imposed on the trust due to its location in South Dakota. To illustrate, assume an Illinois resident creates a dynasty trust governed by South Dakota law. Since the settlor is an Illinois resident when the trust becomes irrevocable, the trust will be treated as a resident trust for Illinois income tax purposes and thus subject to Illinois income tax. Nevertheless, because the South Dakota trust can avoid transfer taxation, it will provide a total of $1.7 billion to the family at the end of 85 years compared to $777 million if the trust were governed by Illinois law. This compares favorably to the $1.9 billion provided by the "pure" South Dakota trust (i.e., one created by a South Dakota settlor or one in which the income tax of the settlor's domiciliary state could be avoided). In other words, an Illinois settlor who creates a South Dakota Dynasty Trust can obtain 90 percent of the benefit provided by the "pure" trust

($1.7 billion divided by $1.9 billion). These results are illustrated in Exhibit D.

A Trust Situs In South Dakota

How does a non-resident settlor ensure that his dynasty trust will have a South Dakota situs so that it will be governed by South Dakota law and accordingly not be subject to the rule against perpetuities? Generally, the settlor of a trust that is funded with personal — as opposed to real — property may designate the state whose laws he wishes to govern the validity and construction of the trust, as long as the state has a substantial relationship to the trust. See Restatement, Conflicts of Law, 2d, Secs. 268 through 270; Wilmington Trust Co. v. Wilmington Trust Co., 24 A. 2d 309 (DE, Ch. 1942). Whether a particular state has a "substantial relationship" to the trust is a question of fact. A favorable determination can usually be obtained if the designated state is the one where the trustee main-





tains its place of business or where the trust assets will be administered. In most cases, this should be equally true whether the trust is established under a Will or during the settlor's lifetime. In the typical case, the settlor will choose a South Dakota bank as trustee and deliver the assets to the bank for administration in South Dakota.

On the other hand, the validity and construction of a trust of real estate is normally determined by the law of the state where the property is located. Thus, a non-resident settlor who wishes to establish a South Dakota Dynasty Trust should not fund it with out-of-state realty interests.

As to existing trusts, it should be possible to move the situs to South Dakota, assuming that the trust instrument provides for such a change (e.g., by permitting the trustee or the beneficiaries to change the situs) or at least does not prohibit a change of situs. Of course, if the existing trust was created in a jurisdiction where the rule against perpetuities applies, the trust instrument will most likely contain a savings clause providing for vesting or termination of the trust at the end of the perpetuities period. Insofar as the trust interests will terminate or vest as provided in the trust instrument despite the change of situs, no significant benefit would be achieved by moving the trust to South Dakota.

South Dakota Inheritance Tax

On beneficiaries. The South Dakota inheritance tax will not apply upon the death of any beneficiary of the trust. This is because no beneficiary has any vested right in the trust assets unless the assets have actually been distributed to him or her.

On non-resident settlor. Transfers by a non-resident to a South Dakota Dynasty Trust, whether made inter vivos or by Will, are not subject to South Dakota inheritance tax, provided the state in which the settlor resides extends reciprocity to South Dakota residents for similar transfers made by them and provided further that the trust's assets are intangibles. S.D. Cod. L. Secs. 10-4-4 and 10-4-5.

On resident settlor. Under the South Dakota inheritance tax statute, transfers which are intended to take effect in possession or enjoyment at the death of the settlor are subject to the tax. S.D.Cod.L. Sec. 10-40-2(3). Although there appears to be no South Dakota authority on point, case law from other jurisdictions suggests that such an inheritance tax might be imposed where the trust income cannot be distributed during the settlor's lifetime. E.g., *Estate of Crowell*, 56 Cal. App. 3d 564, 128 Cal. Rptr. 613 (1976). The dynasty trust will ordinarily not prohibit distributions during the settlor's lifetime, so this case law should not be controlling. Moreover, other (non-South Dakota) case law indicates that such an inheritance tax would not apply if the settlor had divested himself of all interests in the trust property, even if distributions were deferred until the time of the settlor's death. E.g., *In re Heine's Estate*, 100 N.E. 2d 545 (Probate Ct., Hamilton Co., Ohio 1950).

If the transfer is made by the South Dakota resident within one year of his death, or is made via a testamentary dynasty trust, the transfer will be subject to the South Dakota inheritance tax. S.D. Cod. L. Secs. 10-40-1(1), 10-40-2(1). (The statute creates a refutable presumption that transfers within one year of death were made in contemplation of death.)

Other Jurisdictions

As mentioned above, there are two other jurisdictions in which the rule against perpetuities does not apply. These states also are candidates for the situs of a perpetual trust, although they both have the disadvantage of a (relatively high) state income tax.

Wisconsin. The rule against perpetuities is not recognized in Wisconsin. Wis. stats. Ann. Sec. 700.16(5). The state does have a rule against suspension of the power of alienation which is similar to that of South Dakota. Wis. Stats. Ann. Sec. 700.16(1)-(4). Wisconsin has a state income tax which has a marginal rate of 6.93 percent on taxable income over $15,000.

Idaho. Idaho does not recognize the rule against perpetuities. *Locklear v. Tucker*, 69 Idaho 84, 203 P.2d 380 (1949). By statute in Idaho the power to alienate real property cannot be suspended for longer than a period determined by lives in being at the creation of the limitation plus 25 years. Idaho Code Sec. 55-111. An exception is allowed for a contingent remainder in fee on a prior remainder in fee which takes effect if the persons to whom the first remainder is limited die before age 21 or otherwise have their estate determined before majority. Idaho Code Sec. 55-202. Idaho's state income tax reaches a rate of 8.2 percent on taxable income over $20,000.

Delaware. Although the common law rule against perpetuities does not exist in Delaware, by statute a perpetuities period is provided under which vesting can be postponed for as long as 110 years. Del. Code Ann. Sec. 25-503. For purposes of the rule, powers of appointment are deemed to have been created at the time the power is exercised, and no interest is void under the rule unless it is void if created at the date of exercise of the power of appointment. Del. Code Ann. Sec. 25-501. Delaware has a state income tax with a marginal rate of 7.7 percent for taxable income over $40,000. III.

Drafting Considerations

"Single Pot" Trust v. "Family Lines" Trust. The dispositive terms of the South Dakota Dynasty Trust can take any one of many forms. The trust may be structured as a "single pot," i.e., a continuing sprinkle trust in which principal and income are available to all descendants in the trustee's discretion. The "single pot" approach gives the trustee the flexibility to treat, for example, all grandchildren equally, whereas they would be entitled to only their respective parent's share if a separate, *per stirpes* trust approach were used. The single pot trust may be easier to administer insofar as it will tend to be larger. In particular, the advantage of economies of scale may more easily be achieved for purposes of investments.

The settlor may prefer instead an approach which breaks the trust out along family lines. A separate trust would be created for the benefit of each child and that child's lineal descendants. This approach avoids the conflicts that might arise when different children (or their descendants) compete for a share of the "single pot." Moreover, it encourages additional contributions to the trust, since the person making the contribution will know that her contribution will be earmarked for her family's share of the trust. The main disadvantage of separate trusts for each family line is that it tends to cause a proliferation of smaller trusts which are difficult to administer and can add to administrative fees.

Corporate or individual trustee. A dynasty trust is an ideal candidate for a corporate fiduciary. A corporate fiduciary provides continuity of management, which is of the utmost importance in a perpetual trust. Moreover, a corporate fiduciary offers neutrality, which can become important where various family members are involved. The trust will extend over many generations, most of whose members are not even known at the time that the settlor establishes the trust, and friction may develop between the various beneficiaries. A corporate fiduciary also offers professional management and is more likely to be aware of changes in tax, trust and other laws over the course of the many years that the trust will be in existence.

The settlor may feel uncomfortable naming a corporate fiduciary as the sole trustee of the dynasty trust. An individual, either a family member or a trusted adviser, may be named to act as co-trustee. Alternatively, one or more individuals may be given the right to remove the corporate fiduciary for appropriate reasons.

Special powers of appointment. It is often desirable to give at least some of the beneficiaries special testamentary powers of appointment that will enable them to change the dispositive terms of the trust. Such changes may be appropriate where circumstances arise that were unknown to the settlor at the time the trust was created. Usually the settlor will want to limit the potential appointees of such powers to his descendants and perhaps the spouses of descendants. The use of special *powers* of appointment is easier with the "family lines" approach as opposed to the "single pot" approach. If special powers of appointment are given in a "single pot" trust, the power might extend to a pecuniary amount.

A special power of appointment does not cause the property subject to the power to be includable in the powerholder's taxable estate. Under the Proposed Regulations for the GST tax, however, the exercise of a non-general power of appointment is treated as a transfer subject to a federal estate tax or gift tax with respect to the *creator* of the power if the power is exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any specified life in being at the date of the creation of the trust plus a period of 21 years (plus if necessary a reasonable period of gestation) or, alternatively, the 90-year period under the Uniform Statutory Rule Against Perpetuities. Prop. Regs. Sec. 26.2652-1(a)(4).

This proposed regulation has been criticized on the grounds that its purpose is unclear. As long as the proposed regulation exists, however, it may present an obstacle to the use of powers of appointment in the South Dakota dynasty trust. That is, any exercise of the power to appoint the property in further trust would have to comply with the regulation, and this would effectively limit the duration of the trust to the perpetuities period specified in the regulation. It is hoped that this proposed regulation will be withdrawn (*see* Covey, ed., *Practical Drafting* (U.S. Trust), p. 3132) or at least clarified in a way that will make it inapplicable to states that do not have perpetuities restrictions.

Trustee's power to terminate or amend. The trustee should be given the power to terminate or amend the trust if the continuation of the trust in its original form would be unduly burdensome or otherwise unwise. Termination or amendment could also be authorized if tax or other legislative changes make the continuation of the trust inadvisable. The settlor might state explicitly his purposes in creating the trust and authorize the trustee to terminate or amend the trust if such purposes were being thwarted for any reason.

Charitable gift-over. Any well-drafted trust includes a provision for the possibility that the time may come when no beneficiary of the trust is living. In view of the expected longevity of the South Dakota Dynasty Trust, the use of a charitable gift-over becomes especially important. Since a termination due to lack of beneficiaries could occur literally hundreds of years in the future, it would be advisable to name several alternative charitable takers. Better yet, the settlor could state in detail her charitable intent so that this intent can be carried out by the trustee if none of the charities named by the settlor is in existence when termination occurs.

Trust assets. The trustee should be relieved of the duty to diversify trust investments. The lack of a diversification requirement is especially important insofar as an interest in a family business may be the main asset of the South Dakota Dynasty Trust. Real estate should be discouraged. Non-South Dakota real estate in particular would be inconsistent with South Dakota situs for the trust.

Life insurance may be a suitable asset for the trust, in order to provide leveraging. Insurance could be acquired on the life of one or more very young beneficiaries, with very positive results. If insurance is contemplated, it is advisable to include language authorizing its acquisition and retention as a trust asset and detailing the trustee's duties with respect to this asset, including appropriate exculpatory language. If "Crummey" withdrawal powers are included in the trust, the trustee should be sensitive to the possibility that the powerholder can become the "transferor" for GST tax purposes as to amounts in excess of the "5 & 5" limitation.

Spendthrift clause. One of the main advantages of a dynasty trust is that it allows protection against a beneficiary's creditors and a beneficiary's estranged spouse seeking alimony or support upon dissolution of marriage. For this reason it is advisable to include spendthrift language in the trust. While the South Dakota Supreme Court has not ruled on the validity of spendthrift trust provisions, the federal Court of Appeals for the Eighth Circuit concluded in a 1980 decision applying South Dakota law that the South Dakota Supreme Court would enforce the spendthrift provision at issue. *First Northwestern Trust Company of South Dakota v. Comm'r*, 622 F.2d 387 (8th Cir. 1980). Moreover, by statute in South Dakota, the beneficiary of a trust holding real estate may be restrained from disposing of his interest. S.D. Cod. L. Sec. 43-10-12. The spendthrift clause may be superfluous in view of the discretionary nature of the trust, but it is an added safeguard. If the trustee's discretion is tied to a standard, creditors might be able to reach trust corpus, in which case spendthrift language would be useful. The trustee should be authorized to withhold distributions from any beneficiary who has creditor or marital problems.

A truly perpetual trust such as the South Dakota Dynasty Trust brings into focus even more clearly than the nonperpetual dynasty trust an important truth in estate planning.

Other drafting points. The trust instrument should contain language authorizing the trustee to refuse to accept property if the addition of the property to the trust would cause the trust to lose its zero inclusion ratio for GST tax purposes.

If the settlor expects that one or more descendants who are disabled may be beneficiaries of the trust, it would be advisable to include "supplemental needs" provisions to protect the trust principal from the reach of governmental or other care providers.

It is important that the trust instrument grant the trustee the power of sale, so that there will be no violation of the rule against suspension of the power of alienation in South Dakota. The trust instrument might also contain cautionary language regarding investment in real estate, so that the trustee does not inadvertently become subject to the state's statute limiting accumulation of income from real estate.

The trust should of course contain provisions regarding South Dakota situs and South Dakota governing law.

The term "spouse" as used in the trust instrument should be defined in such a way as to take into account possible divorces and remarriages of beneficiaries.

The trust may be drafted as a "defective" trust, i.e., as a grantor trust for income tax purposes. This will cause trust income to be taxed to the grantor. This could be advantageous, as it could reduce the grantor's taxable estate and serve to enlarge trust principal.

The perpetual trust may also be a suitable vehicle for the "incentive trust" espoused by some practitioners. See R. Adams, "The Future of the Golden Rule," TRUSTS & ESTATES (Jan. 1993), p. 10. The basic concept here is that trust distributions are keyed to the amounts that a beneficiary earns through his own employment. The incentive trust encourages beneficiaries to work and not become layabouts dependent on the trust for survival. As trust principal mushrooms over the generations, the incentive trust features of the South Dakota Dynasty Trust could become extremely important.

Conclusion

A truly perpetual trust such as the South Dakota Dynasty Trust brings into focus even more clearly than the nonperpetual dynasty trust an important truth in estate planning, namely, that property held in trust is generally more beneficial than property held outright. Most people think that outright ownership is preferable because of the control that it gives. Such control is illusory, however, in a world where asset value may be eroded by such factors as litigation from creditors or divorce settlements and, most certainly of all, by taxes. In this world, which is the world of the 21st century, the South Dakota Dynasty Trust offers protective armor for generations to come.◊

FOOTNOTE

1. This article was written prior to the reenactment of the 55 percent highest marginal tax rate. All examples are based upon a 50 percent rate.

Pierce H. McDowell III is an assistant vice president and personal trust officer with Norwest Bank, South Dakota, N.A. McDowell received his law degree from the University of South Dakota, following receipt of his undergraduate degree from Arizona State University. Prior to joining the bank, he practiced law with Woods, Fuller, Shultz & Smith, P.C. of Sioux Falls, S.D.