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America Builds an Aristocracy

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AMERICANS have always assumed that wealth comes and goes. A poor person can work hard, become rich and pass his money on to his children and grandchildren. But then, if those descendants do not manage it wisely, they may lose it. “Shirtsleeves to shirtsleeves in three generations,” the saying goes, and it conforms to our preference for meritocracy over aristocracy.

This assumption is now being undermined, however, through the increasing use of so-called dynasty trusts. These estate-planning instruments enable affluent people to provide their heirs with money and property largely free from taxes and immune to the claims of creditors. And rather than benefit only children and grandchildren, dynasty trusts provide for generations in perpetuity — truly creating an American aristocracy.

Congress is feeling pressure to deal with taxes on inherited wealth, which have fallen to zero this year thanks to lawmakers’ inaction. In the process, it should address the more pernicious problem of dynasty trusts.

This type of trust is new because until very recently most states had a “rule against perpetuities,” which limited the term of any family trust to about 90 years, after which time the family members would own the property outright. This rule derived from the idea that property is best controlled by the living.

In the mid-1990s, however, many states repealed the perpetuities rule, and now any wealthy American can set property aside for his heirs forever, simply by hiring a trustee from one of these states.

What caused state legislatures to abandon a rule that had existed since the late 1600s? Banking industry lobbyists persuaded them that it would be a lucrative move because it would bring business to their states. But it was Congress that set the stage nearly 25 years ago.

In 1986, Congress instituted the generation-skipping transfer tax. This closed a loophole in the estate tax by ensuring that property would be subject to tax as it passed through each generation, even if it would otherwise have avoided estate taxes because it was held in trust. (It prevented “generation skipping.”) However, in enacting this tax, Congress gave each taxpayer a $1 million exemption, which was raised over the years to $3.5 million.

Naturally, estate planners began to create trusts that could take advantage of the exemption, and avoid taxes for the term of the trust. The term, however, was limited by the rule against perpetuities.

Bankers then realized that if they could persuade their state legislatures to repeal that rule (as well as state income taxes on trusts), they could attract business. And in more than a dozen states the banking lobbyists were successful. The rule against perpetuities was repealed, and dynasty trusts — tax-exempt trusts that could benefit generation after generation of heirs — were born.

This did generate business. One study found that nearly $100 billion in trust funds moved to states that repealed their rule against perpetuities.

Dynasty trusts can grow much larger than the $3.5 million exemption amount would suggest. A couple can, for example, put $7 million (their two $3.5 million exemptions) into a life insurance policy owned by the trust. They apply their exemption at the start, and the trust is forever free from taxes — even when, after the death of the second spouse, the life insurance policy pays off at $100 million. Alternatively, a trust can use the $7 million as seed money for a profitable business that the trust then owns.

An ordinary trust dissipates as money is distributed to the beneficiaries. But a dynasty trust can avoid this by discouraging outright distributions and instead encouraging trustees to buy, for the use of the beneficiaries, things like houses, artwork, airplanes and even businesses. Because the trust retains ownership, the assets can pass tax-free and creditor-proof to the next generation.

Beneficiaries don’t pay taxes on the use of this property. In contrast, a worker whose employer provides housing or other benefits is taxed on those benefits.

But tax breaks are not the only special advantages that dynasty trusts provide. Even more troubling, they commonly include a “spendthrift clause,” which provides that trust assets cannot be reached by a beneficiary's creditors. If a beneficiary causes a car accident, for example, the victim cannot be compensated with assets from the trust, even if they are the driver's only resources. So beneficiaries are free to behave as recklessly as they like, knowing that their money is forever protected for themselves and their heirs.

Surprisingly, dynasty trusts can also be bad for the beneficiaries themselves. Many wealthy people agree with Andrew Carnegie and Warren Buffett that it is not in their children's best interest for them to be given so much wealth that they don't need to work. Dynasty trusts rob future parents of the ability to decide this for their children, because the ancestor creating the trust is the one who determines how much wealth each generation of his descendants will receive.

What can be done to eliminate these trusts? A state-level solution is unlikely, since all 50 states would need to act in unison. But Congress could fix the problem by limiting the generation-skipping-transfer exemption to trusts that last no longer than two generations. After that, beneficiaries of a trust should be subject to tax, like everyone else. Then America would not have to face the uncontrollable growth of a new aristocracy.

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