

# Estate Planning: The Power of Now

In recent times, there have been competing proposals regarding federal estate tax from Democrats and Republicans in Congress.

Democratic legislators have introduced multiple bills to increase the maximum rate of federal estate tax and decrease the amount permitted to pass at death free of tax. For instance, Senator Bernie Sanders, a registered independent from Vermont who often caucuses with Senate Democrats, introduced the “For the 99.8 Percent Act,” which proposes a maximum estate tax rate of 77%. In support of his proposal, the Vermont senator tweeted that the fairest way to reduce wealth inequality was to enact “a progressive estate tax on the inherited wealth of multimillionaires and billionaires.”

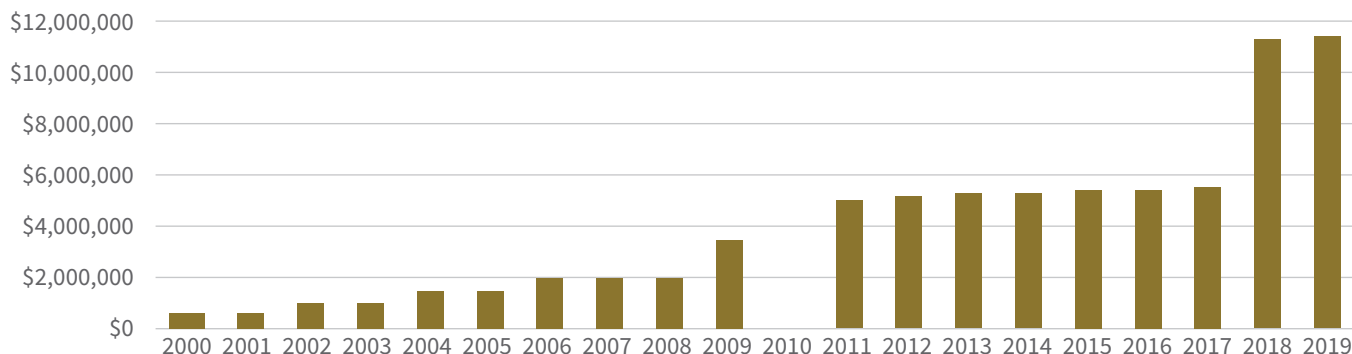
Conversely, Republicans have a long history of opposing estate tax and even repealed it for a year in 2010. Perhaps as a response

to Sanders’ proposal, Senator John Thune (R-South Dakota) recently introduced the “Death Tax Repeal Act of 2019,” which seeks to abolish the estate tax.

Under current law, the maximum rate of estate tax at death is 40%, with the amount exempt from tax – referred to as the “applicable exclusion amount” – sitting at \$11.4 million for individuals who pass away in 2019. This means, in the event of death, a married couple using both their exclusions can leave their heirs \$22.8 million without paying federal estate tax.

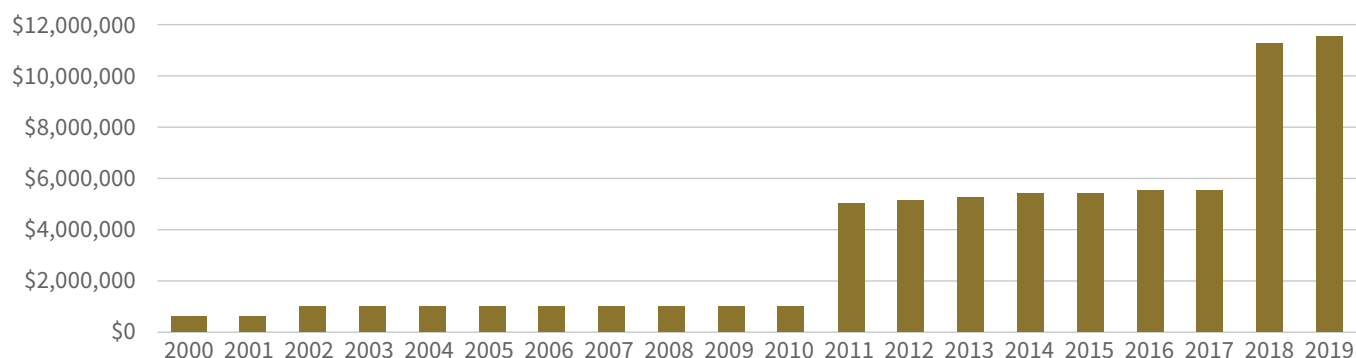
The following charts illustrate the increase of the estate and gift tax exclusions over the past two decades:

ESTATE TAX EXCLUSION SINCE 2000



<sup>1</sup> Gift tax and estate tax can be thought of as a unified system of transfer tax, with larger gifts made during life aggregated with amounts passing at death. The gap in the estate tax exclusion chart for 2010 reflects the one-year repeal of the estate tax in that year.

## GIFT TAX EXCLUSION SINCE 2000



The sizable exclusions against estate and gift taxes currently in effect mean that very few American families will be subject to these taxes. Out of those who passed away in 2018, only about 4,000 estate tax returns are expected to be filed with the IRS and less than 2,000 of those returns will show any due estate tax. This means that under current law, only about one-tenth of 1% of people who died in 2018 left estates owing any estate tax.

Given the current political stalemate in Congress, it is unlikely that either Sanders' 77% estate tax or Thune's repeal has a realistic chance of being enacted in the near term. However, this does not mean that the law won't change. Under current law, estate and gift tax exclusions on January 1, 2026, will revert to 2017 levels (indexed for inflation over the intervening period). More importantly, elections in 2020, 2022 and 2024 may result in dramatic changes to the system before 2026. Whether we enact Senator Sanders' systems or Senator Thune's repeal, or legislation that lies in the middle, is yet to be seen.

### WHY DOES THIS MATTER?

Imagine that the estate and gift tax exclusions were a company's stock. Let's assume that the value of this stock has gone up 18-fold over the past 20 years and has doubled in value over the past two years alone. While this would be a wonderful

investment, mid- and long-term prospects for this company wouldn't be as promising under existing law. Many reasonable investors would seek to lock in their gains. In other words, they would utilize the exclusion at its current levels rather than wait to see the legislation Congress may enact prior to 2026.

You may be wondering how the current exclusion would affect you if you were to make a gift to an individual or trust. Could the IRS try to "claw back" a portion of what you have transferred back into your estate? According to the IRS, the answer is "no." If you make a gift in a year when the exclusion is higher and pass away at a later date when it is lower, nothing would be "clawed back" into your estate. In other words, the gift would secure the use of the exclusion at the current level irrespective of what were to happen in the future.

What does it mean to use the exclusion now? While some families may choose to make outright gifts to the next generation to "lock in" the exclusion, most wealthy clients prefer not to surrender access and control over their wealth during their lifetimes. Instead, clients often choose to set up long-term trusts, also known as Dynasty Trusts, so that their spouses and families can act as recipients of substantial transfers. In the years since the gift tax exclusion expanded so dramatically, wealthy families have relied on Dynasty Trusts to receive transferred wealth.

<sup>2</sup>Tax Policy Center

<sup>3</sup>Proposed Reg. 83FR59343

## WHAT IS A DYNASTY TRUST?

A Dynasty Trust refers to an irrevocable, multigenerational trust that can continue indefinitely, benefiting the successive generations of a family. The assets in a Dynasty Trust can be passed from one generation to another and to successive generations without ever being subject to estate taxes. Dynasty Trusts can also be referred to as “generation-skipping trusts.” This term is misleading, however, because most Dynasty Trusts don’t skip generations. Each generation has the opportunity to use and enjoy the trust assets, later passing the remaining trust assets to the next generation. The “skipping” that occurs in most Dynasty Trusts refers to estate taxes, which are avoided when the trust is passed down through each generation.

A Dynasty Trust can benefit the spouse and descendants of a client while enabling the client to maintain control over the trust and make the important decisions all throughout their lifetime. In fact, Beneficiaries would not need to know about the Dynasty Trust unless the client chooses to tell them about it. Upon the death of the client and the spouse, the trust could be divided into separate trusts for their children and there would be no due estate tax. In the future, trust assets could be used and enjoyed by the beneficiaries and then passed down to a new generation free of estate tax and without concern for claims and liabilities.

As noted above, the Dynasty Trust can receive a lifetime gift in the full amount of the \$11.4 million gift exclusion in effect for 2019. In cases where married couples use both their exclusions, the amount transferred to the trust can be \$22.8 million. Once in the Dynasty Trust, assets are effectively removed from the estate tax system. Here are other notable aspects of Dynasty Trusts:

1. Once in the Dynasty Trust, the growth of assets over time is also exempted from estate taxes. For instance, if an initial gift of \$11.4 million to a Dynasty Trust grows over time to \$20 or \$40 million, this future growth would not be liable for estate taxes.
2. A Dynasty Trust can be structured as a grantor trust for income tax purposes, meaning income earned by the trust is taxed to the grantor of the trust. The grantor can pay this income tax without the payment being considered a gift by the grantor. By paying the trust’s income taxes over time, the grantor effectively shifts wealth from his or her own estate, which would be subject to estate tax, to the Dynasty Trust, which is exempt from estate taxes.
3. At any time, the grantor of a Dynasty Trust can swap assets in the trust for assets of equal value that she or he holds outside of the Dynasty Trust. This enables the grantor to move assets in and out of the Dynasty Trust opportunistically. The general purpose of such swaps is to ensure that at any given time the Dynasty Trust holds the assets that are considered the best candidates for future appreciation.

## UNDERSTANDING DYNASTY TRUSTS

Here’s an example to help illustrate how a Dynasty Trust works:

Let’s assume a client creates a Dynasty Trust in 2019 and funds the trust with assets valued at \$11.4 million, the current amount of the federal gift tax exclusion. As a result, the client’s gift to the Dynasty Trust would be fully covered by the lifetime federal gift tax exclusion, meaning there would be no owed gift tax.

The assets held in the Dynasty Trust are free of estate tax upon the death of the individual who created the trust, as well as free of estate and transfer taxes as the assets are passed down through generations. The Dynasty Trust is also exempt from creditors' claims and liabilities that may be assessed against the creators or the beneficiaries of the structure. Therefore, in addition to being an effective estate planning tool, a Dynasty Trust is also excellent for asset protection planning. The Dynasty Trust can essentially become a permanent endowment that can be passed down from one generation to the other and can remain protected from divorces, lawsuits and other claims for as long as the trust exists.

### COULD THE RULES CHANGE?

If a client creates a Dynasty Trust, funds it in the maximum amount possible under current law and allows it to grow to a greater value, could Congress change the rules to take away some or all of the trust benefits?

While anything is possible, there are several reasons why it could be difficult to change the rules relating to a gift after it has been made. First, the law that is applicable to a gift, including the exclusion amount, is the law in effect at the time when a gift is made. It would be difficult for Congress to change these rules

without a constitutional challenge. Additionally, as previously noted, the IRS has already indicated that, in the event a gift or estate exclusion is reduced in future years, it will not seek to "claw back" gifts made under the current gift exclusion. As a result, most estate planning practitioners hold the view that a Dynasty Trust, once created and funded, serves as a stable planning structure that can survive future legislative attempts to restrict its use.

This is not to say that the legislation regarding these matters won't change. We know it will on January 1, 2026, when the current exclusion sunsets – and perhaps sooner, depending on election results in the intervening years. That is why we think it is incumbent upon clients with substantial wealth to consider using the large gift exclusions available under current law to fund Dynasty Trusts sooner rather than later. The potential benefits of doing this planning now, rather than adopting a wait-and-see approach, are endless.

Please note, changes in tax laws or regulations may occur at any time and could substantially impact your situation. While familiar with the tax provisions of the issues presented herein, Alex. Brown Client Advisors are not qualified to render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.



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