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Estate Planning: The Power of Now

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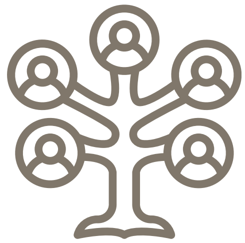


Key Takeaways:

- Uncertainty surrounds federal estate tax laws and the permitted exclusions.
- Creating and funding certain planning structures now lets you “lock in” the exclusions at their current levels, $11.4 million.
- A Dynasty Trust is an effective and proven way to transfer assets free of estate tax to the next generation and to generations to come.

Don’t put off to tomorrow what you can do today. This old adage is true for many aspects of our lives, including estate planning. Current federal estate and gift tax exclusions are set to expire in January 2026. And while this seems like ample time to put a plan in place, the reality is the laws could change before then—and the new rules may not be as favorable.

Legislators from both sides of the aisle have introduced multiple bills that range from increasing the maximum estate tax rate to 77% (currently 40%) to repealing it altogether. With three election cycles before 2026, where we ultimately wind up is anyone’s guess.

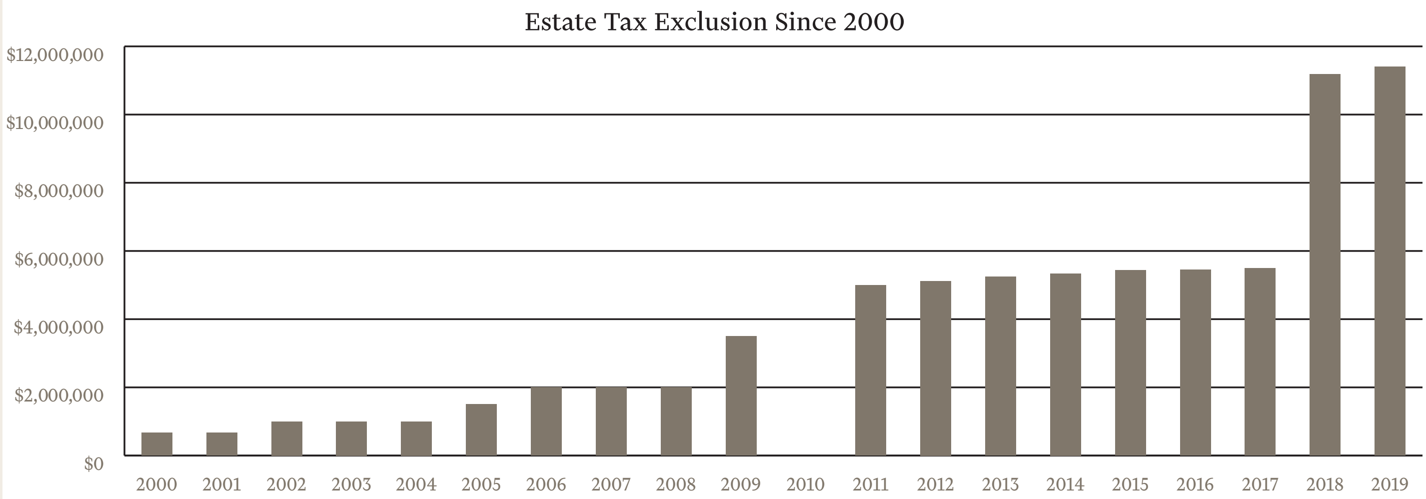
Creating and funding certain planning structures today helps eliminate this uncertainty while potentially minimizing the amount of taxes your heirs pay.

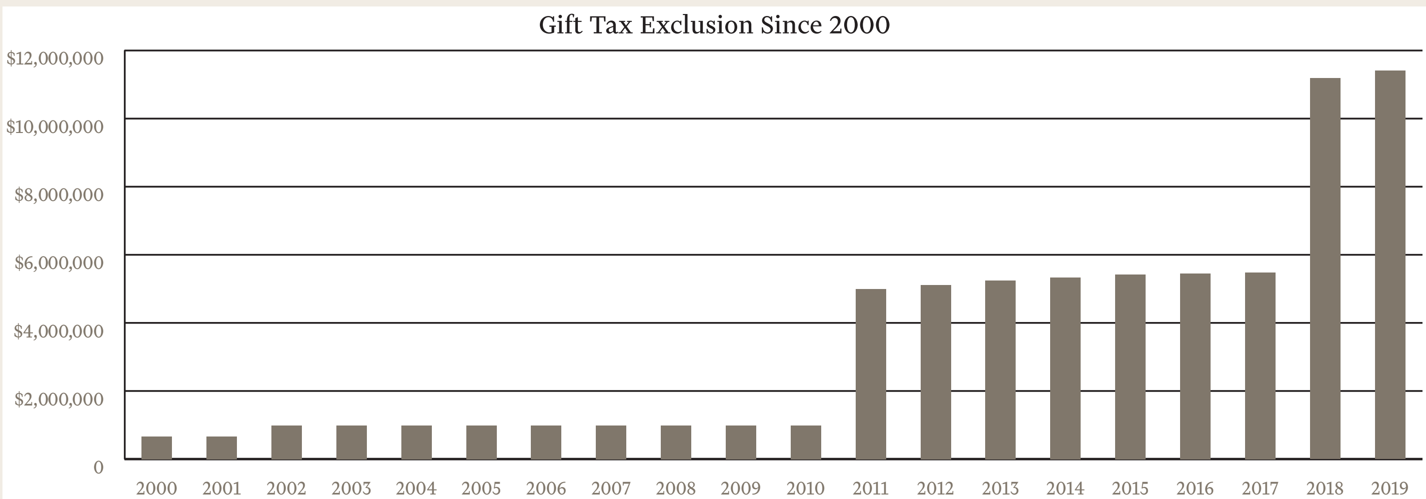
The Potential Cost of Waiting

Under the present rules, few American families actually end up paying estate taxes thanks to the sizable exclusions—$11.4 million for individuals, $22.8 for married couples (2019 limits). However, this could change. Current or future legislators could decide to reduce the exemptions or get rid of them entirely. At the very least, if Congress doesn’t act, the amount you can exclude will decline dramatically in 2026. The exemptions will revert to 2017 levels, which will essentially cut them in half—$5.49 million per individual, $10.98 for married couples.

Think of it this way. Imagine the estate and gift tax exclusions are the stock of a company. The value of this stock has gone up eighteen-fold over the past twenty years, and over the past two years alone has doubled in value. A wonderful investment, indeed, but mid-term and long-term prospects for this “company” are less rosy due to many factors. What conclusion would many reasonable investors draw? It’s time to consider ways to preserve this growth. In other words, use the exclusion at its current lofty levels rather than waiting to see what future Congresses may do.

Worried about what could happen if you act now and the allowable exemptions are later reduced? Could the IRS try to “claw back” a portion of what you have transferred to your estate? The IRS has said no—nothing will be “clawed back” if the exclusion amount is lower at the time of your death. In other words, the gift “locks in” the use of the exclusion at the current level irrespective of what happens in the future.





Note: 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.

Dynasty Trusts: "Locking In" Current Exclusions

What, specifically, does it mean to "use the exclusion" now? Should you make outright gifts to the next generation to "lock in" the exemption? That is certainly one option, but many wealthy families prefer to set up "Dynasty Trusts" to be the recipients of these lifetime gifts.

A Dynasty Trust is an irrevocable, multigenerational trust that can continue indefinitely, benefitting successive generations of a family. The assets can be passed from one generation to the next without ever being subject to estate taxes. These trusts are sometimes referred to as "generation-skipping trusts," which is misleading. With most Dynasty Trusts, the only thing being skipped is federal estate taxes, not people.

Once in the Dynasty Trust, assets are effectively removed from the estate tax system. Each generation can enjoy and use the funds in the trust, sheltered from claims and liabilities, and then pass the assets on to heirs free of estate taxes. Let's look at an example.

Dynasty Trust is Established by John

John funds a trust with assets worth $11.4 million.

Under 2019 rules, the gift to the trust is fully covered by John's lifetime federal gift tax exclusion; no gift taxes are due.

John's Death; Trust Continues for Surviving Spouse Mary

Upon John's death, his wife Mary continues to benefit from the trust. No estate tax is due.

Mary's Death; Trust Continues for Children

Upon Mary's death, the trust is divided into individual trusts for each child. No estate tax is due.

Trust Passes to Next Generation

Upon the death of each surviving child, the assets of that child's trust would pass to the child's heirs. No estate taxes would be due.

Key Features of Dynasty Trusts

As the owner, you retain control of the trust and make all important decisions, including whether or not to tell beneficiaries about its existence. Additionally, Dynasty Trusts offer several features that may influence your decision to create one:

- **Protection of future growth.** Any growth of trust assets is also sheltered from estate taxes. For example, if your initial gift of $11.4 million to the Dynasty Trust grows to $20 million, the additional $8.6 million is exempt from any federal estate taxes.
- **Grantor trust structure.** A Dynasty Trust can be structured as a "grantor trust" for income tax purposes, which means any income earned would be taxable to you rather than the trust. Any income tax payments you make are not considered a gift. By paying the trust's income taxes over time, you can effectively shift wealth from your own estate (which will be subject to estate tax) to the Dynasty Trust (which is exempt from estate taxes). You don't have to pull money out of the trust to cover its income tax liability.
- **Asset swapping.** As the owner (grantor), you can "swap" assets at any time for those of equal value held outside the Dynasty Trust. Moving assets in and out helps ensure the trust is always holding the assets believed to offer the best opportunity for future appreciation.
- **Asset protection.** Dynasty Trusts are free from creditors' claims and liabilities that might be assessed against you or your beneficiaries. It can essentially become a "permanent endowment" for your family that can be passed down from generation to generation and can provide protection from divorce, lawsuits and other claims for as long as the trust exists.

Important Considerations

If you create a Dynasty Trust today, fund the maximum excludable amount possible under current law, and give it time to grow to an even higher value, could future Congresses change the rules to take away some or all of the benefits?

Of course, anything is possible. However, it's generally difficult to change the rules relating to a gift after it has been made. Here's why:

- The law applicable to a gift (including the exclusion amount) is the law in effect at the moment when a gift is made. It may be hard for Congress to retroactively change the rules without a constitutional challenge.
- Moreover, as noted previously, the IRS has already signaled that it will not seek to "claw back" gifts made under the current gift exclusion in the event the exemption is reduced in the future.
- Dynasty Trusts, as described in this article, are viewed as a stable planning structure and as such, would likely withstand any legislative attempts to restrict their use.

This is not to say, however, that the rules in this area will not change. We know in fact that they will—on January 1, 2026, and perhaps sooner depending upon the results of elections in the intervening years. Given this, individuals and families of wealth should consider using the substantial gift exclusions currently available to fund Dynasty Trusts sooner rather than later. The benefits of planning now are invaluable.

Put Our Expertise to Work for You

Our planning specialists have extensive experience helping clients implement Dynasty Trusts and other wealth transfer solutions to achieve their estate planning goals and mitigate taxes. Contact one of our advisors to learn more.

Paul is the Chief Planning Officer and a Partner in the New York office. He has over thirty years of experience in helping families create and optimize their wealth planning structures. His expertise extends beyond traditional trust and estate planning to areas such as asset protection planning, income tax strategies, charitable and philanthropic structuring, and planning for international families and individuals.