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Texas Amends its Rule against Perpetuities

In this Issue:

What exactly is the rule against perpetuities you ask, and why should you care? Well, maybe you still won’t care after reading further, but this is a major change in Texas law that will become effective on September 1, 2021 and that could have significant estate planning implications for some Texans.

The purpose of the rule against perpetuities is to prevent property interests from being tied up for many generations in a trust after the trust creator’s death. Thus, a provision in a trust that grants a property interest to a beneficiary who will be born several generations into the future will possibly be invalid under the rule. The Texas Constitution speaks plainly as to the intent of the rule – “Perpetuities and monopolies are contrary to the genius of a free government, and shall never be allowed...” In a recent Texas case, the rule is described as a restriction on the power of alienation that lasts longer than a prescribed period and Texas courts apply the rule against perpetuities as a check on vain and capricious action by wealthy empire builders.

Here’s an example of how this might work. Someone (parents, grandparents, etc.) creates and funds an irrevocable trust with a significant gift naming you as the primary beneficiary of the trust’s income for your life. When you die, your surviving descendants will step into and assume your role as beneficiary. And this will happen for each successive generation of your descendants. In effect though, no one really “owns” the trust assets; the primary beneficiary merely has limited rights to access the income and principal from those assets for life. The current rule against perpetuities limits the length of time this trust can last (assuming its assets don’t get depleted over time) to those who were living at the time the trust was created, plus another 21 years. After that period of time in trust, the assets must be distributed in fee simple to the then existing beneficiaries. In practical terms, a trust that was planned to extend as long as possible in line with the current rule may last approximately 80 - 100 years assuming normal beneficiary life expectancies and a very young future beneficiary who is alive at the time the trust is created.

So what is the real motivation behind creating trusts that last for centuries? It has to do with estate taxes. A family's wealth that is individually owned by the family members is subjected to estate taxes at each generational level. But wealth that is held in a properly drafted irrevocable trust for the benefit of multiple generations of your family is not subject to estate tax as each generation dies. This is precisely how prominent American families such as the Kennedys have navigated around the estate tax since the tax came into existence in 1916. So multigenerational irrevocable trusts have become best practice planning tools for estate planners for decades.

What will this new rule do? For new Texas trusts created after September 1, with proper drafting they may be able to extend trusts for a maximum of *300 years*, without violating the perpetuities rule. The term "perpetuity" implies something that lasts forever, and while 300 years isn't *technically* forever, for all practical purposes most people probably view it as such.

There are provisions in the new law that allow some existing irrevocable trusts to qualify for the new perpetuities period. Alternatively, trust reformation may be an option to judicially modify existing trusts to meet the new rule. Competent tax counsel should be obtained if you pursue this avenue as there may be some adverse tax consequences associated with a trust reformation.

Wisdom

Discipline

Confidence

To Plan or Not to Plan...

On May 28, 2021, President Biden released the Fiscal Year 2022 Budget, and the "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," which is commonly referred to as the "Green Book." The Green Book summarizes the Administration's tax proposals contained in the Budget. The Green Book is not a proposed legislation and each of the proposals will have to be introduced and passed by Congress. But it reveals those revenue proposals that President Biden favors and supports.

As to individual income tax provisions, the most provocative of Biden's proposals include taxing long term capital gains at the highest individual tax rate, and treating transfers of appreciated wealth during life or at death (gifts and inheritances) as a taxable disposition resulting in income tax. It is unclear whether donations of appreciated property to charity might also get swept up in this net.

President Biden's proposals would be effective for gains required to be recognized after the "date of announcement," which date is *not specified* in the Green Book. It is possible that this date refers to April 28, 2021, which is the day on which President Biden made a speech to Congress and released a fact sheet describing the "American Families Plan." While Congress would make a final determination regarding effective dates of any proposals which may be enacted, it is interesting to note the potential consequence of a "date of announcement" effective date.

Knowing this, should taxpayers sell or transfer appreciated assets before Congress passes any new laws in 2021? It appears the possible retroactive effective date could serve to slow taxpayers from selling assets who have the goal of recognizing gains prior to a rate increase. The risk is you go to the effort to plan to avoid the higher rates and find that your actions are already subject to the new rules!

Some general observations are in order regarding new tax angles for capital gains, should President Biden's proposal pass:

- The combined top long-term capital gains rate of 43.4% is not the highest rate ever applied in

U.S. tax history. However, it would be the highest in modern times as well as the highest of the 38 OECD countries.

- The top rate would apply only to the portion of gains exceeding a taxpayer's AGI of $1,000,000. Gains are added into the equation after considering all other sources of income.
- As an example of a $1,000,000 gift of an appreciated asset, if the taxpayer has no remaining gift tax exemption, there would be a 40% gift tax AND 43.4% capital gains income tax on the same transfer, for an effective tax rate of 83.4%. You might want to rethink this planning strategy!
- For estate tax purposes, income taxes due by the decedent have traditionally been an estate tax deductible liability. Presumably this concept would remain in place and would mitigate somewhat the negative impact of the double taxation.
- The proposal appears to impose a type of mark to market regime on not only long-term dynasty trusts but also partnerships and other non-corporate entities.
- It is also unclear whether distributions from trusts of appreciated property will constitute realization events.
- There are many more "what if's" that far exceed the scope of this article.

So should you contact your tax advisor and do planning before yearend (and before any legislation passes) to mitigate the imposition of these proposed new rules? It's an individual call. If you do nothing, and the law passes or is retroactive back to April 28, you're at the mercy of the new rules. If you take some planning actions, and new law retroactively applies to those actions, then you're in the same place, except that you have potentially accelerated some tax consequences that might otherwise have been deferred into the future – but would not be avoided.

Perspective

Strength

Who is the 'top 1%"?

There is much political discussion about income inequality in America. You hear about a group of individuals called the "top 1%" of all income earners, and immediately think about billionaires such as Bezos, Buffett, Gates, and other mega-wealthy individuals. But based on a 2020 article by USA Today, it only takes an annual income of $538,926 on average across all states to be in the top 1% club for that year. This number is derived from the IRS as reported on tax returns filed in 2017 (and inflation adjusted). The article noted that wealth is more concentrated in certain parts of the country than in others, accordingly, the amount it takes to be in the top 1% in each state varies considerably.

Noted American economist Thomas Sowell wrote a book in 2019 entitled *Discrimination and Disparities*. This work gathers a wide array of empirical evidence from a variety of sources to challenge the idea that different economic outcomes can be explained by any one factor, whether it is discrimination, exploitation or genetics. Sowell takes a close look at the statistics used by the experts as foundation and support for their income inequality assertions. Certain statistics are cited by Sowell as containing errors of *commission*, such as lumping together data on things that are fundamentally different, such as salaries and gains, producing numbers that are simply called "income". But these two sources of wealth are fundamentally different.

Other cited errors of commission include discussing statistical brackets as if they perfectly and permanently describe "the rich", "the poor", or "the top one percent". Further, a significant distinction is drawn between (1) annual wages, salaries and other incomes earned and paid during the same year and (2) income from capital gains accrued over a number of years and then liquidated into cash (and referred to as income) during a given year.

Take for example a married couple in Texas whose combined salaries are at the Texas average of $81,734 per year. Having lived in their personal residence for 20 years and selling it in today's real estate market could easily result in a capital gain on the sale of their home that would push them into the 1% category. Yes, the gain on the home sale was realized in a single year, but the appreciation was earned over the 20 year investment period. The same holds true with other investment assets.

The reality is that lower annual incomes are far more likely to be made up of salaries and wages and very high annual incomes are far more likely to be the result of capital gains. Sowell notes that membership as a one percenter is generally a transitory status for most of this group. Internal Revenue Service data reveals that half the people who earned over a million dollars a year at some time between 1999 through 2007 did so just once in nine years. Another study based on tax data showed that among Americans with the 400 highest incomes in the country, fewer than 13 percent were in that very high bracket more than twice during the years from 1992 to 2000.

Because of the high turnover rate in high income brackets, there can be thousands of people in the "top 400" during just one decade. For example, there were 4,584 people from 1992 to 2014 in the top 400 income earners according to the Internal Revenue Service. Of these, 3,262 were in this bracket just one time in those 22 years. Sowell surmises that when incomes earned by thousands of people are reported as though they were being received annually by hundreds of people, there is a significant exaggeration (in this case, a tenfold exaggeration) of income disparities.

This reference to the "top 1%" has evolved as a political talking point surrounding the income inequality debate. These individuals, it is argued, do not pay their fair share of taxes. There is some truth that the wealth from this group continues to grow much more rapidly than the bottom 99%, further widening the wealth gap. But some facts need to be stated before you look at the members of this club with disdain for not paying their fair share. According to the Congressional Budget Office, sources of annual taxes collected by the US Government include:

- Individual income taxes – 51%
- Corporate income taxes – 6%
- US estate taxes – 2%
- Payroll taxes – 34%
- Customs, excise taxes, other taxes – 7%

The fact remains, the top 1% account for more annual income taxes paid than the bottom 90% combined. While the political climate searches for solutions to income disparities, the real question is whether a "Robin Hood" approach to taxing the wealthy will actually close the wealth gap, particularly if the Administration is aiming its efforts at a transient group? Will those new proposed tax dollars actually go toward raising the wealth of the bottom 99% or merely be applied toward funding the social or other agendas of the party in power?

View Capital Advisors, LLC was founded in 2004 by its principals with the mission of providing sophisticated investment asset management and financial and estate planning to our U.S. and Non-U.S. clients.

We seek to bring wealth planning best practices and a wide range of non-proprietary solutions to our clients. We also conduct our own research and diligence on world markets and investment alternatives.

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