WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Life Insurance Planning Insights from the 2015 Heckerling Institute.

MARKET TREND: Clients focused on both income tax and estate tax planning are seeking a new balance from advisors that minimizes their overall tax exposure.

SYNOPSIS: The 2015 Heckerling Institute on Estate Planning addressed how legacy and succession planning has evolved since enactment of the American Taxpayer Relief Act of 2012 ("ATRA"). The Heckerling presenters focused on: (1) the right balance between income and estate tax planning, emphasizing basis management and planning flexibility, (2) "hot" topics for the IRS, including grantor trusts, GRATs, and installment sales, (3) the widespread use of irrevocable lifetime trusts, like life insurance trusts, and the importance of trustee selection and powers, and (4) how to view and present life insurance as a flexible way to diversify the assets held by individuals and trusts.

TAKE AWAY: Advisors must think differently in how they approach clients regarding tax and legacy planning. Those advisors who can clearly demonstrate how life insurance can serve multiple objectives (income, retirement, and liquidity planning, family security etc.) as part of a client's overall plan will be in the best position to reach new clients and maintain relationships with existing clients.

The following provides an overview of some of the life insurance observations from the 2015 Heckerling Institute on Estate Planning, which we will discuss on March 24th on the AALU *Essential Wisdom Series* Webinar, "2015 Heckerling Highlights: Practical Insights for Life Insurance Advisors" and also explore in upcoming *WRMarketplace* reports.

FOCUS REMAINS ON BALANCING INCOME AND ESTATE TAX PLANNING

As we moved into the third year of planning under ATRA, the significant overlap between estate tax and income tax planning for many clients has solidified. The narrower gap between the top income tax and transfer tax rates, combined with higher estate tax exemptions and greater basis step-up at death, make the lifetime wealth transfer analysis far more sophisticated. Any estate tax reductions that can result from transferring assets, particularly highly appreciated assets, out of the estate must be balanced against the loss of a basis step-up. To achieve a “balanced” plan for these clients, planning must: (1) analyze both state and federal tax laws, (2) facilitate basis management, (3) preserve estate tax exemptions, and (4) maximize flexibility. For example:

Grantor Trusts. Grantor trusts will continue to serve as the basis for many legacy and succession plans because they can meet all three of the above criteria:[1]

- The grantor’s payment of the trust’s income taxes reduces the value of the grantor’s estate and allows the trust assets to grow without a reduction from taxes while also not including the assets the grantor’s estate at death.
- The grantor can engage in sales or exchanges with his or her grantor trust without incurring gain recognition (although the assets sold will take a carry-over basis).
- The basis of the trust assets can be managed by giving the grantor a non-fiduciary power to substitute trust assets for those of an equivalent value, which allows the grantor to reacquire low basis assets for inclusion in his or her estate and substitute high basis assets in the trust.
- The trust can be drafted to provide flexibility to adjust to altered circumstances so that grantor trust status can be changed in the future , transferring the income tax burden to the trust.

Zero-Gift Planning. Planning approaches that result in minimal or no taxable gifts, such as zeroed-out GRATs, installment sales to grantor trusts, etc., can result in a reduction of the client’s taxable estate without diminishing the federal estate tax exemption that will help maximize the basis step-up at death.

Flexibility for Basis Adjustment. In addition to substitution powers for the grantor, providing beneficiaries with powers of appointment over trust property can help manage basis step-up issues. Giving a beneficiary a general power of appointment over trust property should trigger inclusion of the assets in the beneficiary’s estate, allowing for a future basis adjustment. For added flexibility, an independent trustee or third party could be given the power to grant a beneficiary a general power of appointment, which could be limited to just trust assets with built-in gain.[2] Conditioning the power on the grant of a third party can help avoid estate inclusion in a beneficiary’s estate unless it made sense under the given tax circumstances.

Why It Matters for Life Insurance

- Most irrevocable life insurance trusts (“**ILITs**”) are grantor trusts and often funded through loans and/or sales that are disregarded for federal income tax purposes. Grantor trust status also provides flexibility with regard policy transfers. A transfer of a policy to the grantor or another grantor trust is disregarded, which can avoid transfer for value issues.
- Life insurance, held outside of the taxable estate, can provide flexibility in determining whether to gift or hold an asset when planning and considering tax implications. The insurance proceeds can offset the additional estate taxes imposed by holding a particular asset until death to obtain a basis step-up.

- The effectiveness of many zero-gift approaches depends on market performance of the assets transferred and the client's survival of the term. Life insurance acts as a non-correlated asset – neither dependent on mortality or market performance – which helps to offset the potential exposure.

Speaking of Grantor Trusts, GRATs and Sales – areas of focus for the IRS

Presenters at the Heckerling noted that GRATs, sales to grantor trusts and the following topics are currently on the IRS "radar screen." The IRS is taking a "kitchen sink" approach in its challenges, raising every possible issue in a deficiency notice even if not raised in examination.[3] Thus, clients and advisors should be prepared for many varied challenges.

Installment Sales to Grantor Trusts. The IRS is reviewing whether the installment note represents bona fide debt. Critical to the examination is whether there is a real expectation of repayment or intent to enforce the debt[4] including whether the trust has a demonstrable ability to pay the debt (i.e., sufficient assets in addition to those purchased).[5] If the IRS disregards the note, it may classify the entire transfer as a gift, which would result in estate tax inclusion of the assets due to the grantor's retained interest (the right to receive note payments) (see discussion in *WRMarketplace No. 15-09)*.

Two companion cases raising these issues, the *Est. of Marion Woelbing v. Commissioner* and *Est. of Donald Woelbing v. Commissioner*, were set for trial before the U.S. Tax Court on March 16, 2015, but the trial date was recently postponed by request of the parties with no new trial date set. This could indicate the parties are proceeding to settlement, which would leave advisors and taxpayers without a judicial resolution or guidance on these issues.

SCINs. The IRS has renewed its focus on self-canceling installment notes ("**SCINs**"), which automatically terminate upon the seller's death, particularly if the seller dies early in the note term. The IRS has targeted SCINs that provide for interest-only payments, as well as those valued using the life expectancy tables under Internal Revenue Code ("**Code**") §7520 tables, rather than using a "willing-buyer/willing-seller standard."[6]

Note Valuation. The IRS also has challenged installment note valuations based on insufficiency of the interest rate or principal,[7] resulting in a taxable gift equal to the difference between the note's re-determined value and the FMV of the property sold.

Defined Value Clauses. As discussed in *WRMarketplace Nos. 12-34* and *12-52,* defined value clauses essentially limit the property transferred to a recipient to a fixed dollar amount. If the value of the property, as ultimately determined for federal gift tax purposes, exceeds the specified amount, the gift is arguably capped. If the formula clause is an "allocation" clause, the "excess" amount will pour over to a charitable or other non-taxable beneficiary (such as a GRAT or a QTIP trust). Heckerling presenters reported some success in negotiating with the IRS on cases that involved these clauses but noted that the IRS reviews them closely to ensure compliance with all formalities. Further, the IRS has signaled a continuing interest in challenging simpler, "*Wandry*-like" clauses, which just limit the gift to a fixed dollar amount, without allocating the excess to any other donee.

<u>GRATs under Audit</u>. Heckerling presenters indicated that the IRS has undertaken significant audit activity with regard to GRATs, looking to confirm that the transaction formalities and annuity payment terms are being respected. Substitution transactions with GRATs also have come under scrutiny, with the IRS carefully reviewing whether the swapped properties have equivalent values, whether the property was properly valued and formalities followed, etc. (see *WRMarketplace No. 14-08* for a discussion of GRATs).

<u>Assets Valuation & Discounts</u>. Disputes with the IRS over asset valuation and the applicability and size of discounts remain a major focus in the transfer tax arena for gifts or sales of closely-held business interests, real estate, and other hard-to-value assets.

<u>Family Limited Partnerships ("FLPs")/Family LLCs ("FLLCs")</u>. The IRS's major argument in this long-debated area is that the FLP/FLLC assets should be pulled back into the decedent's estate based on the decedent's retained interest in (though an implied agreement) or control over those assets (see Code § 2036). If using these entities, clients must have a legitimate and significant non-tax purpose for creating the entity, follow all formalities, minimize control, and avoid any indications that they have an implied agreement to enjoy the entity's property (see *WRMarketplace No. 13-10* for a list of "dos and don'ts" in FLP/FLLC creation, funding, and administration).

Why It Matters for Life Insurance. The above approaches often complement life insurance planning and may be used to fund policies.

MORE TRUST PLANNING = GREATER CARE IN TRUSTEE SELECTION AND POWERS

Lifetime irrevocable trusts, like irrevocable life insurance trusts ("**ILITs**"), have long been a mainstay in life insurance planning. Their widespread use, however, has lead to certain misconceptions about the ease of implementation. Unlike wills and revocable trusts, the provisions of an ILIT, especially a dynasty ILIT intended to last for generations, cannot be easily changed to adjust to future circumstances or tax laws. The trust document must be carefully customized to the client's particular circumstances and include provisions that will allow the trustee and trust to adapt to changing needs. Important considerations that may be easily overlooked include the following:

<u>Trustee Selection</u>. The selection of the trustee is one of the most important decisions for clients but often is made with little understanding about the duties and obligations of the role. Family members and friends generally are ill-equipped to make investment decisions or comply with the technical administrative requirements for the trust. Also, these individuals may struggle with their fiduciary duty of loyalty to the trust beneficiaries and their personal loyalty to the grantor, which may adversely impact their decisions. Thus, clients may want to consider bifurcating the trusteeship, by appointing a distribution trustee (someone familiar with the family) to handle distributions and a professional trustee to handle investments and administrative duties (see *WRMarketplace No. 2014-41*for a discussion of selecting ILIT trustees).

<u>Independent Trustees</u>. While beneficiaries can serve as trustees, any distributions they make to themselves must be limited to an ascertainable standard (*e.g.*, for health, education, maintenance, support). Appointing an "independent" trustee (someone who is not a beneficiary nor related or subordinate to the grantor or a beneficiary) provides for greater trust distribution flexibility and potentially increases creditor protection. Independent trustees often can take certain actions with regard to an ILIT policy and/or property (such as decanting to another trust, see below) that a beneficiary-trustee cannot.

Waivers of Certain Trustee Duties/Powers. Most states require a trustee to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. Further, state law often requires the trustee to diversify trust assets. For ILITs, these requirements generally will be more restrictive than desired, since the grantor generally will want the trust to retain life insurance, without any need to diversify. Thus, the ILIT agreement could give the trustee the broadest possible investment discretion and waive any duty to diversify, where consistent with applicable state law.

Trustee's Ability to Decant. Decanting is a process that allows a trustee to transfer assets from an existing irrevocable trust to a new or another existing irrevocable trust, which may have different terms. Decanting can provide an efficient alternative to expensive judicial trust modification proceedings and may be used to achieve a wide range of goals, including adapting to changing beneficiary needs and/or tax and economic circumstances over the long-term. Where permitted by state law, ILIT agreements, particularly for dynasty ILITs, should include provisions for decanting. (see *WRMarketplace No. 14-21* for a discussion of decanting).

Why It Matters for Life Insurance. Proper trustee selection and trust administration is often critical to preserving the intended transfer tax treatment of ILITs; otherwise the life insurance proceeds could be pulled back into the grantor's estate. The ability to decant can provide significant flexibility for ILITs, especially for policy transfers. For example, an existing ILIT can transfer a policy to another ILIT without a sale, and thus avoid the need for policy valuations and funding of the purchasing trust (though gifts, loans, etc.) so it can buy the policy. The ability to decant to a new ILIT with more desirable provisions become particularly important if the grantor becomes uninsurable and acquiring a new policy through a new trust is no longer a viable option.

PRESENTING LIFE INSURANCE AS A FLEXIBLE WAY TO DIVERSIFY[8]

Many permanent life insurance products have components that can serve as a flexible way to diversify an individual's or trust's portfolio. Pertinent considerations include:

- Life insurance can provide a client's estate with an immediate and substantial source of liquid assets at a predictable value, a benefit not found in other assets.

- Under appropriate applicable tax laws and principles, cash value life insurance products (particularly current assumption universal life and whole life): (1) the growth in cash value typically is not subject to income tax; (2) typically access to cash value through loans and withdrawals (up to basis) is generally not subject to taxation if the product is not a modified endowment contract ("**MEC**"); and (3) typically death benefit proceeds are not subject to income taxation.

- Depending on the product, a policy owner who acquires coverage for insurance purposes also may have the flexibility to consider increasing premiums or reducing policy death benefits to meet the policy owner's evolving insurance, asset and investment needs.

- As a trust investment, clients can maximize their gift tax annual exclusions, gift tax exemptions, and legacy planning approaches to take advantage of the death benefits provided relative to the amount of insurance premiums paid.

Why It Matters for Life Insurance. These days, as advisors work with clients seeking a "balanced plan", the preferred approach will be to show that life insurance can serve multiple objectives (*e.g.*, income, retirement, and liquidity planning, family security etc.), using concrete illustrations of how a policy can fit into a client's overall investment plan.

TAKE-AWAY

- Advisors must think differently in how they approach clients regarding tax and legacy planning.

- Those advisors who can clearly demonstrate how life insurance can serve multiple objectives (income, retirement and liquidity planning, family security etc.) as part of a client's overall plan will be in the best position to reach new clients and maintain relationships with existing clients.

NOTES

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[1] Assuming there are no changes in the tax laws applicable to grantor trusts. See discussion in *WRMarketplace No. 15-05* discussing the President's budget proposals to change the transfer taxation of grantor trusts.
[2] See Steve R. Aker's discussion of these issues in *Heckerling Musings 2015 and Current Developments*, February 2015 at http://www.bessemer.com/advisor; "SCINs and Private Annuities: Disappearing Value or Disappearing Strategies?," presented January 13, 2015, and "Planning with SCINs and Private Annuities – Seizing Opportunities While Navigating Complications," presented January 14, 2015, both at the 49th Annual Heckerling Institute of Estate Planning, January 2015.
[3] See John W. Porter, "The 30,000 Foot View from the Trenches: A Potpourri of Issues on the IRS's Radar Screen," presented January 13, 2015 at the 49th Annual Heckerling Institute of Estate Planning, January 2015; Steve R. Aker's discussion of these issues in *Heckerling Musings 2015 and Current Developments*, February 2015 at http://www.bessemer.com/advisor.
[4] *See*, *Estate of Costanza v. Commissioner*, 320 F. 3d 595 (6th Cir. 2003), *rev'g,* T.C. Memo 2001-128.
[5] *See Estate of Marion Woelbing v. Commissioner,* T.C. No. 30260-13, and *Estate of Donald Woelbing v. Commissioner,* T.C. No. 30261-13.
[6] *See Estate of Davidson v. Commissioner*, T.C. No. 013748-13; Treas. Reg. § 25.2512-8.
[7] *See Estate of Marion Woelbing v. Commissioner,* T.C. No. 30260-13, and *Estate of Donald Woelbing v. Commissioner,* T.C. No. 30261-13.
[8] See Charles L. Ratner, "Insurance as a Tax-Advantaged Investment," as part of the presentation "Life Insurance as an Asset Class" presented January 14, 2015 at the 49th Annual Heckerling Institute of Estate Planning, January 2015. In contrast to the title of the above, the AALU consistently emphasizes that life insurance is not only a vital part providing financial security, its current tax treatment is not only appropriate, but also fully consistent with long-standing tax law and principles.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or

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WRM #15-10 was written by Greenberg Traurig, LLP
Jonathan M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012