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: 2014 Year-End Wealth Transfer Planning: Opportunities

MARKET TREND: Recent changes in Congress make major tax reform in the immediate future increasingly unlikely, although certain reform proposals may be looming on the horizon. Thus, advisors should be aware of planning clients can implement now to manage high income tax rates and take advantage of wealth transfer opportunities.

SYNOPSIS: Continuing high income tax rates, combined with low interest rates, a robust stock market, and higher transfer tax exemptions, provide an ideal environment for wealth transfer strategies, particularly grantor retained annuity trusts ("GRATs"), intra-family loans, installment sales to grantor trusts, split-dollar loans and life insurance products. Although the 2014 federal income and transfer tax rates and exemptions will carry into 2015 largely unchanged, tax proposals developed in 2014 shed light onto possible 2015 reforms, including changes that could impact the life insurance industry, transfer tax rates and exemptions, and the advantages offered by grantor trusts.

TAKE-AWAYS: This is an opportune time to revisit each client's estate plan with an eye towards managing taxes and taking advantage of currently available wealth transfer strategies and the markets. Life insurance products continue to play a vital role because of their unique properties – a source of liquidity without imposition of income tax, efficient wealth transfer on a multi-generational basis, and solid internal rates of return ("IRRs") relative to the market. When included as part of a freeze technique (such as a GRAT or an installment sale to a grantor trust), life insurance can also provide an ideal hedge against the grantor's mortality.

PRIOR REPORTS: 14-27; 14-15; 14-13; 14-12; 14-10; 14-08; 13-16.

As the end of 2014 draws near, clients are looking for strategies to manage their taxable income and efficiently transfer wealth to family members. This is an opportune time for advisors to revisit each client's income and wealth transfer planning strategies with an eye towards taking advantage of the current low interest rates, higher transfer tax exemptions, and a strong market.

BE CAREFUL OUT THERE - AREAS TO WATCH IN 2015

Earlier this year, the Chairman of the House Ways and Means Committee released a discussion draft of the "Tax Reform Act of 2014" ("**Discussion Draft**"), and the President released his budget and revenue proposals for FY2015 ("**Proposed Budget**") (see discussion in

WRMarketplace No. 14-10). While neither the Discussion Draft or Proposed Budget (or other significant tax reform) likely will be raised during the remaining lame-duck session, they provide insights into various tax reform proposals that could be introduced as legislation in 2015.

Life Insurance. Both the Discussion Draft and the Proposed Budget contain proposals that would impact the life insurance industry, including provisions that would:

- Limit excluded company-owned life insurance ("**COLI**") policies solely to those policies insuring 20% owners and expand interest deduction limitations related to those policies.
- Modify the dividends received deduction and impose other tax increases on life insurers;
- Impose specific reporting requirements and limit exceptions to the transfer for value rule for life settlements; and
- Make very harmful changes to non-qualified deferred compensation.

If enacted, these proposals would translate into higher product costs and lower IRRs broadly for life insurance consumers.

Wealth Transfer Planning/Management. The Proposed Budget contains proposals that would impact estate, gift and generation-skipping transfer ("**GST**") taxes, which can create planning uncertainty and hesitation among clients, including:

- Returning to 2009 transfer tax rates/exemptions: Reinstatement of 45% transfer tax rate, $3.5 million estate and GST tax exemptions, $1 million gift tax exemption.
- Curtailing the use of grantor trusts for wealth transfer planning: Imposition of estate tax on irrevocable grantor trust assets.
- Elimination of short-term GRATs: Imposition of a 10-year minimum term for GRATs and possible elimination of zeroed-out GRATs.
- End of a dynasty: Imposition of a 90-year limit on GST tax exemption for trusts.
- Turning down the HEET: Elimination of GST tax deferral benefits for health, education and exclusion trusts ("**HEETs**").

CURRENT PLANNING ENVIRONMENT

The 2014 federal tax rates, thresholds, and exemptions will carry over into 2015 largely unchanged (e.g., top individual income tax rate of 39.6%, long-term capital gains rate of 20% and transfer tax rate of 40%), except for an increase in the federal unified gift and estate tax exemption from $5.34 million to $5.43 million.[1] In addition, the income threshold for application of the limitation on itemized deductions (the so-called "Pease limitation") will increase to $258,000 in 2015 ($309,900 for married couples filing jointly).

Going forward, tax planning should continue to emphasize income tax deferral and reduction. In addition, since combined federal income, capital gains and NII taxes are close to the maximum 40% federal transfer tax rate, wealth transfer planning also should involve a comparison of the income tax consequences of gifts versus bequests. Finally, planning strategies will want to take advantage of the current low interest rates and the strong market.

WHAT WE'RE SEEING

Wealth transfer planning remains focused on "estate freezes," a trend likely to continue into 2015 based on current tax laws and market conditions. Freeze techniques popular in the current environment include zeroed-out GRATs, intra-family (AFR) loans, installment sales to grantor trusts and split-dollar loans – here's why:

- They can allow the taxpayer to minimize the taxable estate while preserving the federal estate tax exemption for elimination of estate taxes and attainment of basis step-up at death;

- The original value of transferred property can largely be returned to the donor (critical for donors concerned about ensuring adequate lifestyle funds); and

- Grantor trust status increases the potential for a successful wealth transfer, especially in a high income tax environment.

Zeroed-Out GRATs. With a zeroed-out GRAT, the grantor transfers assets to the trust, retaining a right to an annuity payment for a specified term with a present value equal to the fair market value of the assets transferred. There is no taxable gift upon funding, which preserves the federal estate tax exemption for use at the grantor's death (i.e., to reduce estate taxes and achieve a basis step-up). GRATs transfer asset appreciation in excess of a federally-set 7520 rate to the trust's remainder beneficiaries without gift or estate tax.[2] Thus, a GRAT's success is directly tied to active management of the trust and its assets (see *WRMarketplace No. 14-08* for a detailed discussion of GRATs).

<u>Active Management</u>

Use of Short-Term Rolling GRATs. Investment volatility in a long-term GRAT can undermine the benefit of a low 7520 rate for a GRAT's overall performance. The selection of the term and structure for the GRAT must compare the anticipated annual performance of the underlying assets (not just the total average return) to the applicable 7520 rate, as well as factor in the mortality of the grantor.

Short-term (e.g., 2-year) GRATs provide a hedge against an asset's volatility and the mortality risk of the grantor's death during the term, minimizing the risk of estate tax inclusion. If a client wants to capture an asset's volatility, a series of short-term GRATs (so-called "rolling GRATs") can have a "smoothing" effect from a return perspective, by capturing interim investment volatility and avoiding offsetting periods of growth and depreciation, while enabling the grantor to transfer each annuity payment to a new short-term GRAT.

The Power of Substitution. A GRAT also can provide a hedge against asset volatility by giving the grantor a non-fiduciary power to substitute or swap trust assets for assets of an equivalent value. The grantor can exercise this power to either bail out an underperforming GRAT or lock in the gains of an exceedingly successful GRAT.

> ***Example***: Grantor created a 3-year, zero-out GRAT funded with 30,000 shares in X Co. At funding, the share price was $66 ($1.98 million total), and the 7520 rate was 1%. In Year 1, the shares increase in value to $83/share (almost 26%, for a total gain of $510,000). In Years 2-3, however, the share price falls and stays at $68 per share. Compare the outcomes if the grantor leaves the shares in the GRAT, or in Year 1, substitutes a bond portfolio with a 3% average return.

End of GRAT Term – Year 3	Substitution	No Substitution
GRAT Remainder	$560,721	$143,260
Potential Estate Tax Savings (at 40%)	$196,252	$50,141

- ***Advisor Alert***. Interested clients may want to act now. As previously noted, the Proposed Budget seeks to eliminate both short-term and zeroed-out GRATs.

Intra-Family Loans & Installment Sales to Grantor Trusts. Other "freeze" techniques include intra-family loans and installment sales to grantor trusts, the performance of which are keyed into prevailing interest rates and grantor trust status during periods of high income tax rates. Installment sales also provide an efficient tool for GST tax planning, since the donor only needs to allocate GST tax exemption to the initial "seed" gift to the trust (typically 10% of the value of the assets sold). The assets purchased by the trust do not require an additional allocation of the exemption, which offers a significant leverage to the transaction, especially when used in conjunction with funding for life insurance.

- ***Advisor Alert***. The IRS has looked more closely at certain intra-family sale transactions, and the Proposed Budget seeks to curb the use of sales to grantor trusts and to limit GST-exempt dynasty trusts (see *WRMarketplace No. 14-13* for a discussion of installment sales to grantor trusts and *WRMarketplace No. 13-16* for a discussion of the Proposed Budget's grantor trust proposal).

Split-Dollar Loans. Split-dollar ("**SD**") loans will continue to be a powerful planning tool for using the acquisition of large life insurance policies. With private SD loan arrangements, the grantor makes interest-bearing loans to his or her irrevocable life insurance trust ("**ILIT**"), to pay the policy premiums. The ILIT has an obligation to repay the loans at the specified maturity dates, typically secured by a limited collateral assignment of the policy to the lender. If the loan provides for sufficient interest (generally, the federally-set AFR), it is governed by the general tax rules for debt instruments. The lender has no specific powers over, or interest in, the policy apart from the security interest. The ILIT retains all rights to the policy's cash value and death benefit, subject to the obligation to repay the loans.

- ***Advisor Alert***. As with installment sales, changes in the tax treatment of a grantor's transactions with his or her grantor trust could adversely impact the economics associated with SD loans.

MULTI-GENERATIONAL PROTECTION & TAX DEFERRAL

The use of discretionary, multi-generational dynasty trusts can enhance the benefits of estate freezes and wealth transfer planning. Although GRATs are not efficient tools for GST tax planning, ILITs and grantor trusts used with installments sales can be structured as dynasty trusts to maximize use of the GST tax exemption. Dynasty trusts also can minimize client concerns regarding outright transfers to descendants and provide a vehicle for creditor protection and wealth management while assets remain in the trust.

- ***Advisor Alert***. The Proposed Budget would subject dynasty trusts to GST taxes upon expiration of 90 years, thus limiting the deferral benefits of perpetual trusts.

HIGHER INCOME TAXES = MORE WEALTH TRANSFERS / MORE PHILANTHROPY / MORE ACTIVE MANAGEMENT

More Wealth Transfers. Higher income taxes, low interest rates, higher transfer tax exemptions, and a strong stock market, provide incentives to enter into wealth transfers, as described above. Using grantor trusts as part of these transfers, where the grantor pays the income tax on the trust's income, further facilitates this wealth transfer planning, allowing the trust assets to grow without imposition of income tax. In contrast, non-grantor trusts reach the highest income tax rate (39.6%) and are subject to the 3.8% NII tax with income of just $12,150 ($12,300 for 2015). With such low thresholds, most non-grantor trusts will be subject to higher income tax rates unless the income is distributed to the beneficiaries.

More Philanthropy. Higher income tax rates also spotlight the importance of charitable planning. The use of private foundations, donor advised funds and charitable lead annuity trusts can be very effective income and estate tax planning tools for clients who are philanthropically inclined. The use of such planning should be a catalyst for life insurance because: (i) the client will get an immediate income tax deduction (savings that could potentially fund premiums) and (ii) the wealth contributed to charity may need to be replaced in a more efficient fashion – likely an ILIT.

More Management. Higher income tax rates will also necessitate closer attention to asset allocations (income versus growth, taxable versus tax exempt, timing of gains and losses). Income tax planning should also take into consideration the use of life insurance, annuities, and similar investments to provide opportunities for growth without imposition of tax. Trustees of both grantor and non -grantor trusts may need to alter the trust's investment strategies, possibly using insurance products, to manage the overall tax burden to the grantor or the trust, respectively. Trustees of non-grantor trusts also should compare the benefit of distributing income to beneficiaries in lower tax brackets against the costs of placing such income at risk of a beneficiary's creditors and increasing a beneficiary's own taxable estate.

LIFE INSURANCE – KEY COMPONENT

Life insurance will continue to play an important role in income tax and wealth transfer planning for the balance of 2014 and throughout 2015. Life insurance is a "triple threat" income tax planning tool which can provide:

- Investment growth within the policy without imposition of income and NII taxes – this is especially important in states with high income tax rates;

- Access to cash value via loans and withdrawals (non-modified endowment contracts) without imposition of income and NII taxes; and

- Death benefits for heirs without imposition of income, NII, and potentially estate/GST taxes.

Proceeds from life insurance policies held outside of the insured's estate, such as in an ILIT, can be used to offset estate taxes while allowing assets in the insured's estate to achieve a stepped-up basis for capital gains tax purposes. Life insurance held outside of the estate also will increase flexibility by avoiding the untimely sale of assets.

The inclusion of life insurance in a freeze structure provides a unique hedge for success when the planning is highly dependent on market performance and the grantor's mortality/longevity (such as a GRAT or an installment sale to a grantor trust). In addition, if a strategy is challenged, life insurance can provide protection by offsetting any additional transfer taxes that may be imposed on the insured's death.

TAKE-AWAYS

- This is an opportune time to revisit each client's estate plan with an eye towards managing taxes and taking advantage of available wealth transfer strategies and the. GRATs, intra-family loans, installment sales to grantor trusts and split-dollar loans can provide effective strategies.

- Life insurance products continue to play a vital role because of their unique properties – a source of liquidity without imposition of income tax, efficient wealth transfer on a multigenerational basis, and solid IRRs relative to the market.

- When included as part of a freeze technique (such as a GRAT or installment sale to a grantor trust), life insurance also provides an ideal hedge against the grantor's mortality.

NOTES

[1] Note that while federal tax rates and exemptions remain largely unchanged, several states made changes to their income and transfer tax systems that will take effect in 2015, including New York, Illinois, Maryland, Minnesota, Rhode Island and Tennessee. Thus, advisors also should review and confirm the impact of any state tax changes for clients when implementing planning.

[2] As noted below, however, GRATs generally are not efficient for GST tax planning.

DISCLAIMER

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