WRMarketplace
An AALU Washington Report

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.

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TOPIC: Year-End Planning Post-Election: Where Do We Go From Here?

MARKET TREND: The potential for major tax reform is here, and change always breeds opportunity. Inertia is not a plan.

SYNOPSIS: What we don't know: while a Republican President and a Republican-controlled Congress increases the likelihood of major tax reform, there is a lot of uncertainty as to the final outcome, including whether there will be estate tax repeal, and if so, whether it will be replaced with another tax (like a capital gains tax at death), and whether proposed regulations under Internal Revenue Code §2704, dealing with valuation discounts for family-controlled entities, will be withdrawn. What we do know: providing liquidity for business succession, earnings replacement, family security, blended family planning, income tax management, etc. will likely take center stage. Flexible, multi-faceted planning that can address both practical and tax issues and offer tax-deferral and management will be at a premium. Life insurance may be the optimum solution because of its unique attributes -stability, instant, mortality- based liquidity, and cash accumulation on a tax sensitive basis, to name a few.

To be clear, achieving major tax reform is very difficult, which is why it rarely occurs. Once statutory language is drafted, and specific provisions are down on paper, there tends to be pushback from a variety of affected stakeholders. For instance, net importers might take issue with the border adjustability provision that is a major revenue raiser in the House Republican Blueprint. In addition, there are political and procedural difficulties with using reconciliation that create additional hurdles.

TAKE-AWAYS: Facing the possibility of major tax changes, clients and their advisors must think differently about approaching tax and legacy planning. Finding advisors who are adept at strategic planning in an uncertain environment will be important - cookie cutter approaches, while appearing inexpensive, likely will be costly. If tax laws change, life insurance will continue to play a fundamental role in planning as an all-purpose tool that serves many objectives (income tax, retirement, and liquidity planning, investment management and diversification, family security, etc.). Before year-end, clients should: (1) close pending life insurance purchases to preserve pricing and protect their insurability; (2) proceed with their annual exclusion gifts, as the downside of such gifts remains low; (3) continue with charitable giving, as this year's income tax rates are known and may be the high relative to the future; and (4) engage their advisors for a full audit of their current tax situation to determine the timing of various gains and deductions, especially in anticipation of potentially lower tax rates.

With the Presidential election done and year-end quickly approaching, individuals and families should secure advice to help address their 2016 taxes and to plan proactively for 2017. This is a critical time for clients and advisors to connect and discuss planning options, particularly with the possibility of anticipated tax law changes.

POST-ELECTION TAX CHANGES: OH, THE POSSIBILITIES

With President-Elect Trump and a Republican-controlled Congress, major tax changes are more likely. Below are some changes proposed under the Trump and Republican platforms:[1]

Tax	Currently	Proposed by Trump/ House Republican Blueprint
Individual Income Tax Rates	10%, 15%, 25%, 28%, 33%, 35%, and 39.6%	12%, 25%, and 33%
Capital Gains Tax Rates	0%, 15%, and 20%	Same or reduced to 6%, 12.5% and 16.5%
Corporate Tax Rate	35%	15% or 20%
Net Investment Income Tax	3.8%	Repealed
Alternative Minimum Tax	Applies to income over $53,000 (single); $83,800 (married joint filers (MJR))	Repealed
Estate & Generation Skipping Transfer (GST) Tax	40% (estates & total GSTs over $5.45 million)	Repealed

Capital Gains Tax at Death	None - basis step-up for estate assets	Likely taxed with some exemption ($10 million in Trump proposal)
Gift Tax	40% (total gifts over $5.45 million)	Unclear
Standard Deduction	Standard Deduction: $6,300 (single); $12,600 (MJR)	Combined: $15,000-$18,000 (single); $24,000-$30,000 (MJR)

IMPACT ON PLANNING: SHIFTING GEARS

Dealing with Uncertainty. While the Republican desire for tax reform is strong, uncertainty remains as to the content of any final reforms, including whether the estate tax will be fully repealed, whether a capital gains tax at death regime will apply (and if so, with what exemption amount), whether proposed regulations under Internal Revenue Code §2704, dealing with valuation discounts for family-controlled entities, will be withdrawn, etc. Flexibility in current planning, such as the ability to trigger estate inclusion if basis step-up remains available, will be critical. There may be a return to 2010 planning methods, where documents provided for multiple options regarding distributions and the apportionment of tax liabilities, depending on existing tax laws.

Focusing on Income Taxes. If the estate tax is repealed, income tax issues will dominate legacy planning, with a focus on how they impact lifetime wealth transfers and trust structuring, investment, and distribution management. If capital gains tax applies at death, depending on the available tax exemption, more families may face tax liabilities than under the current estate tax regime. Basis step-up planning may remain critical, continuing the importance of flexible trust planning, such as giving a client a power of substitution over his or her grantor trust to reacquire low basis assets so as to permit a basis management at death (i.e., to take advantage of any available estate or capital gains tax exemption, depending on the applicable tax regime). Multi-faceted planning that can address basis step-up, offer tax-deferral and management, and provide flexibility will be at a premium. Note, however, that the last estate tax repeal bill to pass the House, sponsored by Ways and Means Chairman Kevin Brady (R-TX), retained basis step-up.

Remembering State Tax Impact. State income tax considerations will remain crucial, particularly for trusts, as many states, like New York and California, are enhancing their collection efforts, including collecting income taxes from trusts based on a variety of factors, such as the location of trustees, trust beneficiaries, and/or trust assets (see WRMarketplace No. 15-38). For estate tax purposes, planning will need to address the potential state estate tax exposure for states that retain decoupled estate tax regimes.

Example: A surviving spouse, resident in Washington State, has a $7 million estate. Even with a federal estate tax repeal, she could still owe over $375,000 in Washington state estate tax, which could be difficult to pay in cash if the estate is highly illiquid (e.g., concentrated in the principal residence or other real property).

Emphasizing Practical Concerns. No legacy plan is ever driven solely by tax considerations. Practical issues have long formed and will continue to serve as the basis for legacy planning through trusts and other entities, which can offer several non-tax benefits:

- Centralized family wealth management and succession and the development of a coherent family investment philosophy
- A method for controlling the flow of information and assets to beneficiaries, as well as to teach financial responsibility and stewardship with oversight by family or professional wealth managers/trustees
- Confidentiality and creditor protection for family members (particularly crucial considering recent state court cases like Pfannenstiehl v. Pfannenstiehl, where a divorcing spouse sought to include the other spouse's beneficial interest in a family trust in the divisible marital estate - see WRMarketplace 16-39)
- A vehicle for business succession and family governance of shared assets
- Consolidation of assets in a single ownership structure to facilitate the transfer of diverse investments among generations without creating fractional ownership of underlying assets
- Pooling of assets within the trust/entity to provide greater access to certain investment opportunities and the ability to achieve better diversification and risk allocation

LIFE INSURANCE PLANNING: THE ALL-PURPOSE SOLUTION

Facing uncertainty, clients will want some form of security and flexibility to implement any short-term planning. Life insurance remains a fitting solution, as it serves multiple objectives (e.g., income, retirement, and liquidity planning, family security etc.) as part of a client's overall investment plan.

Complements Non-Tax Planning Needs. Planning for today's "modern" family may include satisfying obligations under marital agreements and providing for children from multiple relationships. Many clients have become more focused on practical concerns, including: (1) minimizing family conflicts, (2) ensuring flexibility for later changes, (3) providing liquidity to support the family and cover expenses after death, and (4) offering creditor protection and long-term wealth and tax management for future generations.

Life insurance, especially if held in trust, can address all these needs simultaneously.

Addresses Tax Concerns. From an income tax perspective, life insurance plays an important role in future planning. Under appropriate and long-standing tax laws and principles, policy death benefits are not subject to income tax at the insured's death, and growth that remains within the policy during the insured life is not subject to current income or capital gains tax. This is especially important for clients in states that impose high income tax rates. Further, with many policies, the policy owner can access cash value up to the owner's basis in the policy without current income tax.[2] Thus, cash value life insurance products may hold significant planning appeal in a post-estate tax repeal world.

For estate tax purposes, clients residing in states with decoupled estate tax systems may still need liquidity to pay the taxes. Furthermore, if a capital gains tax at death tax is implemented, estates with little liquidity and highly appreciated assets may face significant income tax burdens.

Facilitates Investment Management. Many high cash value life insurance products can provide flexible methods to diversify an investment portfolio. Pertinent considerations include:

- Life insurance provides a client's family with an immediate and substantial source of liquid assets at a predictable value, a benefit not found in other assets, which can reduce family conflicts about estate liquidation and distributions.

- 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.

Certain life insurance products, like current assumption universal life and whole life products that typically benefit from a rising interest rate environment, may become particularly attractive. Reviewing analyses that show not only the internal rate of return ("IRR") relative to life expectancy ("LE") for a policy's death benefit, but also an IRR analysis of the policy cash value (during the insured's life) relative to LE can help demonstrate how life insurance can complement a client's broader investment and tax planning goals.

Provides Financial Planning Flexibility. Policies with cash value features not only serve estate planning, but also can supplement lifetime retirement planning. Thus, even if the federal estate tax is repealed, more individuals may look to personal life insurance as a vehicle for providing cash accumulation and retirement savings during life, as well as earnings replacement and family security in the event of an untimely death.

Note on Irrevocable Life Insurance Trusts (ILITs). ILITs will remain important for life insurance planning, since there are numerous reasons for holding life insurance in trust. First, estate tax repeal may not occur or be permanent, in which case an ILIT will ensure that the life insurance proceeds remain outside of a taxable estate.

For ILITs holding just a life insurance policy on the client, basis step-up should not be an issue at the client's death (and ILITs can be flexibly drafted to address basis management if needed for non-policy assets). The more significant incentives for holding policies in ILITs, however, focus on providing creditor protection and long-term wealth management for beneficiaries, particularly at younger ages.

WHAT TO DO NOW

Proceed to Close on Life Insurance. Even with the uncertainty surrounding potential new tax laws, finalizing life insurance purchases will remain sensible in many cases. As shown above, the flexibility of life insurance will allow clients to meet a wide array of needs and to adapt to changing circumstances. The more critical issue, at present, is preserving the client's insurability. Changes in health can occur rapidly and unexpectedly, potentially making clients uninsurable in the future. Further, increase in age and modifications in pricing and available products options may adversely impact policy premiums if insurance purchases are delayed.

Make Typical Annual Gifts. Using annual gift tax exclusions, funding 529 plans, or paying for educational or health care costs of family members will have little downside even if the tax laws change next year.

Complete Charitable Planning. Making charitable gifts this year may have additional benefits, as this year's income tax rates are known and may be high relative to the future.

Consider Timing of Gains & Deductions. If reductions are expected in income and capital gains rates next year, clients will want to consider whether and to what extent they can move tax deductions and losses into this year and postpone gains and income until next.

Review Non-Grantor Trust Plans. Before year-end, trustees of non-grantor trusts should compare the benefits 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 (see discussion in WRMarketplace No. 15-36).

Schedule Discussions with Advisors. Clients should discuss the post-election tax impact with their advisory team to determine their optimum planning strategy for the remainder of this year and for next.

TAKE-AWAYS

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SAMPLE CLIENT LETTER

Dear ____________:

The recent election of a Republican President and a Republican-controlled Congress greatly increases the likelihood of major tax reform in the near future. While the Republican platform proposes reduced income tax rates and the repeal of the federal estate tax, uncertainty remains as to the actual content and technical requirements of the final reforms, if and when passed.

Now is an opportune time to review your current legacy and investment plans to better position you and your family for the future. We feel more flexible, multi-faceted planning that can address both practical and tax issues will be important. And regardless of how tax reform materializes, certain steps should be taken prior to year-end in anticipation of possible changes.

We have attached an article released by the AALU, a trade association closely tracking these important issues, which provides more detail. We urge you to contact us with any questions or to review how these developments might affect you and your family. We will be in touch regarding any future developments and remain available to meet at your convenience.

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NOTES

[1] As set forth at Donald J. Trump for President, https://www.donaldjtrump.com/policies/tax-plan, accessed as of November 10, 2016, and “A Better Way – Our Vision for a Confident America,” Tax Reform Task Force Tax Policy Paper, dated June 24, 2016.

[2] Assuming the policy is not a modified endowment contract (**MEC**).