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**TOPIC: What's Trending: 2016 Heckerling Highlights in the Real World.**

**MARKET TREND:** The evolution in legacy planning will revolutionize the process to accommodate for practical needs, federal and state tax issues, and a changing economic climate.

**SYNOPSIS:** The 2016 Heckerling Institute on Estate Planning identified several critical trends impacting the legacy and life insurance planning business:

- Rising Interest Rates? Typical "estate freezes", like GRATs, intra-family loans, and installment sales, have benefited from the low federally-set Applicable Federal Rate (AFR) and 7520 rate. Yet the Federal Reserve's recent rate hike creates some uncertainty here.
- Higher Tax Rates. As top federal income and long-term capital gains tax rates remain unchanged, income tax issues have become a planning priority for many clients.
- Grantor & Dynasty Trusts. The IRS and the current Administration continue to focus on grantor trusts and perpetual "dynasty" trusts, including irrevocable life insurance trusts (ILITs), spousal lifetime access trusts (SLATs), etc.
- Grantor Trust Transactions. The IRS continues to target transactions using grantor trusts that are disregarded for income tax purposes (i.e., installment sales) and related planning, such as the use of valuation discounts and defined value clauses in gifts and sales.

- The Basis Balancing Act. The question remains – to give or not to give? The narrower gap between the top income and transfer tax rates requires a balance between the benefits that can result from lifetime transfers and the loss of a basis step-up at death.

**TAKE AWAYS:** The current trends emphasize a new paradigm in legacy and life insurance planning, which requires a more customized, multi-faceted approach to balancing a client's needs and dictates active, on-going legacy management rather than passive, static planning. The most successful plans will involve the collaboration of all client advisors – insurance, legal, tax and financial - who can not only help implement the plan, but also monitor performance and provide on-going support.

The following provides some highlights from the 2016 Heckerling Institute on Estate Planning and their real world impact, as discussed in the March 22nd AALU Essential Wisdom Series Webinar, "2016 Heckerling Highlights & the Real World."

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***CHANGE BREEDS OPPORTUNITY***

Clients and advisors may want to act now, as IRS guidance on the following items may dramatically alter the playing field for many common planning approaches.

**IRS Zeroing in – Priority Guidance Plan Items**. The 2016 Priority Guidance Plan confirms the IRS's focus on grantor trusts and related items:[1]

- *Basis of Grantor Trust Assets at Death*. The IRS plans to address whether assets in a grantor trust take a carry-over basis or receive a basis step-up at the grantor's death.

- *Valuation of Promissory Notes for Transfer Tax Purposes*. IRS guidance is expected on whether promissory notes in intra-family loans/sales charge adequate interest (e.g. at AFR) and provide fair market value for the assets sold for gift, estate, and GST tax purposes.

- *Gift Tax Effects of Defined Value Formula Clauses*. Defined value clauses are used in making gifts or sales of difficult-to-value assets to minimize concerns about potential IRS valuation adjustments. Although the Tax Court has upheld these clauses, the IRS has never acquiesced and will issue its own guidance.

- *Family Limited Partnership (**FLP**) Regulations*. The IRS may soon issue proposed regulations that restrict the use of discounts on transfers of interest in FLPs primarily invested in marketable securities, possibly limiting planning associated with those transfers.[2]

- *New Basis Consistency Rules.* The IRS has just issued proposed regulations for the new tax basis consistency and the information reporting rules for inherited assets, which require a beneficiary of an inherited asset to use its estate tax value as its income tax basis and executors of taxable estates to provide the beneficiary and the IRS with information statements that report the inherited asset's estate tax value.[3] These regulations impose: (1) a **zero-tax basis** for after-discovered or omitted assets not reported on estate tax returns and (2) **similar reporting requirements for subsequent gifts of inherited assets**.

**Administration Keeps Focused - Select Green Book Proposals**. Among several renewed transfer tax proposals, the President's FY2017 budget would require:[4]

- *Transfer Taxes on Grantor Trusts.* Trusts that engage in disregarded transactions with a grantor for federal income tax purposes would incur estate tax at the grantor's death and gift tax at termination of grantor trust status or on a distribution during the grantor's life.

- *Minimum Term/Remainder for GRATs.* GRATs would be required to have a 10-year minimum term and a minimum remainder value.[5]

- *Limits on GST Tax Exemption.* A trust's GST tax exempt status would be limited to 90 years.

Transactions with grantor trusts, GRATs, and dynasty trust planning would be significantly curtailed if these proposals were enacted.

## REAL WORLD APPLICATION – QUANTIFYING THE IMPACT (ECONOMICS MATTER)

- *Rising Rates & Freezes.* While many factors play a role in the performance of an estate freeze, even small increases in the applicable interest rate can have a significant effect:

  ***Example:*** Jack creates a five-year GRAT at the March 2016 7520 rate of 1.8% and transfers $5 million in appreciating assets to the trust. The annuity payments to Jack will increase annually by 20%. The present value of Jack's total annuity payments will equal $5 million (i.e., a zero-out GRAT). The average annual growth for the GRAT assets is 6%, leaving $842,200 to the remainder beneficiaries. But if the 7520 rate increases by just 0.6%, to 2.4%, the ***remainder beneficiaries' share is cut by $115,500***.

- *Changes to Grantor Trusts.* The IRS is taking a "global" approach to guidance on grantor trusts and related transactions. Depending on its scope, the guidance could dramatically alter the form and economics of estate and life insurance plans (as most ILITs are grantor trusts) and effectively limit wealth transfer planning.

> ***Example – Elimination of Grantor Trusts:*** Jack, whose life expectancy is 25 years, gives $5.45 million to a trust for his descendants. The trust expects 6% average annual growth (70% income / 30% capital gains). If the trust is a <u>grantor</u> trust, ***$23,390,695*** will remain in the trust at Jack's death;[6] if a <u>non-grantor</u> trust, only ***$13,676,456*** would remain in the trust at Jack's death,[7] a difference of <u>over $9 million</u>.

- *Proposed FLPs Regulations.* Transferring discounted assets in freeze planning enhances the probability that a freeze will outperform the specified rate (AFR/7520 rate). As discounts are often combined with life insurance planning to help an ILIT fund policy premiums or split-dollar exits, these additional restrictions may limit the availability of proposed funding.

> ***Example:*** Jack has formed a "family office" FLP holding $10 million in marketable investments. He sells a 20% FLP interest to his grantor trust for an interest-only, 20-year installment note, charging annual interest at 2.33%. If a 25% valuation discount applies, the note will have a principal value of only $1,500,000. The trust anticipates an average 6% annual return on the assets.

| Comparison | No Discount | 25% Discount | Benefit of Discount |
|---|---|---|---|
| **Value of FLP Interest** | $2,000,000 | $1,500,000 | **+$500,000** |
| **Initial Amount Remaining for Premiums after Debt Service** | $73,400 | $85,050 | **+$11,650** |
| **Trust Balance After Note Term** | $2,700,000 | $3,629,000 | **<u>+$929,000</u>** |

### *THE TIGHTROPE*

Today, advisors must walk a tightrope that balances their client's practical and tax issues.

**<u>Practical Considerations</u>**. Planning for today's "modern" family presents unique issues, which may include satisfying obligations under marital agreements and providing for children from multiple relationships. Accordingly, many clients have become more focused on their 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.

**Tax Issues**. The comparatively lower income and long-term capital gain (**LTCG**) thresholds in the current environment will cause more individuals to face tax at the top income and LTCG tax rates. The net investment income (**NII**) tax and state income taxes can take an additional toll, particularly with states becoming more aggressive in collecting tax revenue. These issues increase the importance of gaining a basis step-up for assets, which must be balanced against any estate planning considerations involving lifetime gifts.

## REAL WORLD APPLICATION – NAVIGATING THE TIGHTROPE

To succeed in this environment, legacy plans must: (1) reflect state and federal tax laws, (2) address basis management concerns, (3) preserve estate tax exemptions, (4) minimize family conflicts, (5) maximize flexibility, (5) provide liquidity, (6) emphasize creditor protection, and (7) offer financial and asset management. The following tools can help achieve these goals:

- *Life Insurance – The All-In-One Tool:*
  - Basis Step-Up: Life insurance, held outside of the taxable estate, can offset additional estate taxes imposed by holding a particular asset until death to obtain a basis step-up according to longstanding and appropriate tax principles.
  - Liquidity: Life insurance provides estate liquidity, which can avoid forced assets sales and family conflicts about estate liquidation and distributions.
  - Conflict Minimization: Life insurance held in various ILITs can provide independent sources of assets for different classes of beneficiaries (e.g. spouse, children from a prior marriage, etc.), also preventing family conflict over estate distributions and investments.
  - Retirement: Policies with cash value features can supplement retirement planning. Generally, under appropriate tax laws, neither the growth in policy cash value nor access to that value through loans or withdrawals (up to basis) is subject to income tax.[8]

- Flexibility: Trust-to-trust transfers of policies between grantor trusts can be accomplished without running afoul of the transfer for value rules, and several options exist for funding premiums, including annual exclusion gifts, lump-sum gifts, split-dollar arrangements, etc.

- Freeze Protection: Effective estate freezes often depend on the market performance of the assets transferred and the client's survival of the term. Life insurance acts as a non-correlated asset with regard to these issues, helping to offset the potential exposure.

- *Freeze Planning – The One-Two Combo.* Planning approaches that result in minimal or no taxable gifts, such as zeroed-out GRATs, installment sales to grantor trusts, etc., can result in both a reduction of the client's taxable estate, according to longstanding and appropriate tax principles, without diminishing the ability to achieve basis step-up at death.

- *Trusts – The Multipurpose Vehicle*. As discussed below, ILITs, dynasty trusts, etc. are customizable, multi-purpose planning entities that can simultaneously provide control, flexibility, and wealth and tax management.

***WHY TRUSTS***

Irrevocable trusts, like ILITs and dynasty trusts, have long been mainstays in legacy and life insurance planning and, through proper drafting and customization, can address a variety of practical and tax issues. Key issues when crafting and implementing trusts include:

**Taxation**

- *Grantor vs. Non-Grantor Trust Status.* Planning must reflect the potential income tax impact to the trust. With grantor trusts, the grantor must pay the trust's federal and state tax liability, but this leaves the assets in the trust to grow.[9] Non-grantor trusts pay their own taxes but are more quickly impacted by the top federal income/LTCG tax rates and the NII tax, due to the low threshold for application (***$12,400*** in 2016).

- *State Tax Impact*. Non-grantor trusts are subject to state income tax if the trust is deemed a resident of the state. The rules for taxation and the determination of residency vary by state, but state residency generally relies on some connection between a state and the trust, such as the residency of the settlor, a trustee, or a beneficiary. As such connections can make a trust a resident in more than one state, an analysis of state tax and residency rules is critical to implementing a trust.

Moving the administration of the trust to a state with different tax rates or rules, changing trustees, and decanting (discussed below) can all effect the residency determination.

- *Distributions & Investments*. Trustees of non-grantor trusts will need to consider the costs and benefits of making more distributions to beneficiaries who are not subject to the NII tax or who may be in lower income tax brackets. Trustees also may need to adjust trust investment strategies to meet their fiduciary duty to manage the impact of the trust's taxes, including managing the amount and timing of income/gain recognition, providing for greater investment diversification and/or shifting asset allocation toward tax-alternate investments, including insurance products, muni-bonds, etc.

**Who's In Charge - Trustee Selection & Powers**. Clients often select trustees without fully understanding a trustee's duties and obligations. Appointing inexperienced or unsophisticated trustees (like family members or friends) can increase the trustee's liability exposure. These individuals also may struggle with their fiduciary duty of loyalty to, or impartiality, among the trust beneficiaries versus their personal loyalty to the grantor. Thus, clients may want to consider (1) using directed trusteeships, where their selected distribution advisor (someone familiar with the family) directs the trustee on distributions and an investment advisor directs trust investments or (2) naming an "independent" trustee (i.e., unrelated or subordinate to the grantor or a beneficiary), who may provide greater distribution flexibility,[10] increase creditor protection, and potentially give the trust more jurisdictional options.

In addition, most states require a trustee to diversify trust assets and to invest and manage those assets as a prudent investor would, by considering the purposes, terms, distribution requirements, etc. of the trust. For ILITs, these requirements may be too restrictive, especially if the ILIT intends to hold only life insurance. Thus, an ILIT should give the trustee the broadest possible investment discretion, waive any duty to diversify, and provide extensive indemnification provisions, where consistent with applicable state law.

**Administration & Liability**. Given the popularity of trusts, it is not surprising that trust litigation is on the rise, and even the broadest waiver and indemnification provisions may not suffice. To help ensure greater protection of the trustees, ILITs, and their policies, trustees must (1) comply with the trust terms and carefully follow all administrative procedures, (2) keep trust beneficiaries informed (e.g., provide notice and/or accountings) as required by the trust or state law, (3) consult with independent advisors (unrelated to the trust grantor or beneficiaries) regarding trust distribution and investment decisions to avoid potential conflict, and (4) document all discussions, reasoning, and decisions made regarding trust assets and beneficiaries (e.g., why a policy was exchanged or surrendered, changes to death benefits, etc.).

**Decanting**. Decanting effectively allows modification to certain provisions of irrevocable trusts by letting the trustee transfer assets from an existing trust to a new or another existing trust, with different terms.[11] Decanting can provide an efficient alternative to expensive judicial trust modifications and may be used to achieve a wide range of goals, including avoiding transfer for value and policy valuations issues when transferring a policy from one trust to another. Where permitted by state law, ILIT agreements should include provisions for decanting.[12]

### *Real World Application – Combination Trust*

The planning flexibility afforded by trusts can be demonstrated with an ILIT/SLAT/dynasty trust combination. For example, assume Jack creates a SLAT for the primary benefit of his spouse, Jane, with the remainder passing in further lifetime trusts to his descendants. Jack gives $5.45 million to the SLAT and allocates his GST tax exemption. The SLAT buys a life insurance policy on Jack with a $10 million death benefit and a significant cash value component. This plan can achieve the following for Jack and his family:

- The trust is a grantor trust but its investment in the policy limits the income tax burdens on Jack since, under appropriate tax principles, growth within the policy and policy loans/withdrawals generally are not subject to income or NII taxes.

- Jack uses his gift and GST tax exemptions but Jane can still benefit from these assets if needed. The SLAT also can access policy cash value to support distributions to Jane.

- The $10 million death benefit provides estate liquidity without creating additional liability.

- As a dynasty trust, the SLAT efficiently uses Jack's GST tax exemption and provides long-term creditor protection and wealth management for Jack's descendants. The trust also can teach his descendants financial responsibility in a controlled setting, for example, by appointing a beneficiary as a co-trustee of his or her own trust.

- For basis planning, an independent person or trustee can have the authority to grant general powers of appointments to Jack's descendants to achieve a basis step-up for trust assets.

## *TAKE-AWAYS*

- The current trends emphasize a new paradigm in legacy and life insurance planning, which requires a more customized, multi-faceted approach to balancing a client's needs and dictates active, on-going legacy management rather than passive, static planning.
- The most successful plans will involve the collaboration of all client advisors – insurance, legal, tax, and financial - who can not only help implement the plan, but also monitor performance and provide on-going support.

**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 recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.**

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## *NOTES*

[1] See *WRMarketplace No. 15-45.*
[2] See *WRMarketplace No. 15-23.*
[3] See *WRMarketplace No. 16-11.*
[4] *See WRMarketplace No. 16-07.*

[5] The minimum remainder would equal the greater of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed).
[6] The trust's income and gains are reportable by, and taxed to, Jack, at his personal tax rates.
[7] The trust's undistributed income and gains are subject to tax at the top federal income and long-term capital gains tax rates, plus the 3.8% net investment income tax.
[8] Assuming the policy is not a modified endowment contract (**MEC**).
[9] The grantor's burden can also be managed by allowing the termination of grantor trust status during the grantor's life or for discretionary reimbursement of the grantor's tax payments by the trust (if allowable under state law).
[10] E.g., not limited to an ascertainable standard, such as for health, education, maintenance, and support.
[11] The requirements for decanting and the extent to which the terms of a receiving trust can differ from the decanting trust vary by state law, although many states will not allow changes to mandatory distribution provisions or certain other mandatory rights of the decanting trust's beneficiaries.
[12] *See WRMarketplace No. 14-21* for a discussion of decanting.