WRMarketplace

An AALU Washington Report

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone. *WRMarketplace* #17-40 was written by Greenberg Traurig Shareholder Jonathan M. Forster.

The AALU *WRNewswire* and *WRMarketplace* are published by AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

TOPIC: Read All About It - The Big Six's "Unified" Tax Framework: Potential Impact & Look Ahead.

MARKET TREND: Tax reform has moved to the front and center of the Congressional agenda.

SYNOPSIS: The so-called "Big Six's" proposed tax reform framework calls for significant reductions in income and corporate tax rates and a repeal of the estate and generation skipping transfer (GST) tax (but is notably silent on the gift tax). The framework is merely an opening gambit as Congress begins serious deliberations on tax reform, and there will be a number of ups and downs as the details of tax reform are developed. Regardless of how the details shift as a final legislative package is crafted, life insurance remains an essential component of a comprehensive and well-balanced financial plan.

TAKE-AWAYS: Change always brings opportunity. Families and advisors should remain consistent in their approach to implementing flexible life insurance and legacy planning, since planning will remain beneficial regardless of the evolving details of tax reform. While enacting tax reform legislation before year-end is an ambitious goal, families should still consult with advisors sooner rather than later to review their current tax exposure and run scenarios regarding the timing of various items of income, gains, deductions, etc. This will allow families to hit the ground running and avoid a year-end "crunch" should tax reform move on a fast track.

On Wednesday, the so-called "Big Six", representing the Trump Administration, Republican Leadership, and the Chairmen of the House Ways and Means and the Senate Finance Committees, released an outline of their proposed tax reform framework ("**Framework**"). As the "unified" vision of Republican tax reform, it reflects concepts from the House Republican's 2016 Tax Reform Blueprint and President Trump's one-page outline of tax proposals released earlier this year. Here is how the Framework compares to current tax laws and how it may address legacy and life insurance planning.

SNAPSHOT COMPARISON

INDIVIDUAL

Tax Provision	Current Tax Law	Framework
Income Tax Rates	10%, 15%, 25%, 28%, 33%, 35%, 39.6%	12%, 25%, 35% (possible 4th bracket on higher income)
Capital Gains Tax Rates	0%, 15%, and 20%	Not addressed
Alternative Minimum Tax (AMT)	On income over $54,300 (single) / $84,500 (married joint filers (**MJR**))*	Repealed
Estate & GST Taxes	40% (over $5.49 million)*	Repealed
Basis Step Up at Death	Yes	Not addressed
Gift Tax	40% (total gifts over $5.49 million)*	Not addressed
Standard Deduction	$6,300 (single) / $12,000 (MJR)*	$12,000 (single) / $24,000 (MJR)
Itemized Deductions	Yes (e.g., mortgage interest, charitable gifts, state/local income taxes)	No, except for mortgage interest and charitable gifts
Personal Exemption	$4,050*	Eliminated

*Subject to annual inflation indexing.

BUSINESS/CORPORATE

Tax Provision	Current	Framework
Income from Pass-Through "Business" Entity	Taxed at individual income tax rates	25%

BUSINESS/CORPORATE		
Tax Provision	**Current**	**Framework**
C Corporation Tax Rate	35%	20%
Corporate AMT	Applies to C corporations	Repealed

THE STARTING LINE

What's Not Addressed? The outline fails to address many specifics, including such items as the treatment of retirement accounts and capital gains, the availability of a basis step-up for asset values at death, and the definition of a "business" for pass-through income tax treatment. Thus, many issues remain open for negotiation.

How Difficult Will It Be? The Framework is the start of Congressional negotiations on tax reform legislation. The outlined proposals would reduce federal revenues by an estimated $2.2 trillion according to the Center for a Responsible Federal Budget, so the Framework is not revenue-neutral for budget reconciliation purposes. Reconciliation allows Senate passage of a bill with 51 votes (instead of 60) if it is revenue-neutral in years **after** the specified window – i.e., 10 years. So, to use reconciliation to pass tax reform, Republicans must either find revenues to offset their tax reductions or rely on a "sunset" provision that returns us to the prior tax regime (as with the 10-year sunset of the 2001 tax cuts under President Bush).

WHAT NOW? BE PREPARED

Republicans would ideally like to wrap-up ***tax reform by year-end***. This is a very optimistic timeframe. But with tax reform as a Congressional focal point, families should position themselves for year-end planning under current law, while staying abreast of tax reform developments:

Consult Advisors. Families should ***consult advisors now*** to review their current planning and 2017 tax items to identify potential income, losses, deductions, etc. Having a general understanding of these issues now lays the groundwork for a prompt response to any tax legislation.

Run the Numbers. With significant reductions proposed in income and capital gains rates, ***families and advisors should "run the numbers"*** to determine the optimal allocation for tax deductions and losses should tax reform take place before 2018. Charitable techniques that can provide income tax deductions to help offset taxable income this year also may be more valuable given current, higher income tax rates. Individuals with deductions or carryforwards for items that may disappear should determine if and how to make current use of these deductions or carryforwards, such as the income tax deduction for federal estate tax paid on items of income received in respect of a decedent.

Move Forward. As indicated, ***most legacy planning will make sense even with tax reform*** and ***preserving insurability now remains important***. Accordingly, families should feel comfortable moving forward with trust and life insurance plans. In particular, life insurance will remain a flexible but prudent method for accomplishing multiple planning objectives. For example, personal cash value life insurance can serve 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, and, as noted, acquisition of a convertible term policy can preserve insurability now without requiring a permanent commitment. ***WHAT IT COULD MEAN - OPPORTUNITIES***

As indicated, the composition of any final tax reform legislation is expected to shift continually over the next few months, and we will provide more detail on AALU's advocacy activities below. Yet the released framework does represent the priorities of the Administration and Republican leaders in Congress. This section explores the implications for life insurance and legacy planning based on some of the Frameworks' proposals.

State Income Taxes: Greater Impact. Loss of the itemized deduction for state income taxes would significantly affect individuals residing in states with higher income taxes (e.g., California, New York), as it effectively raises the combined tax rate on income.

> ***Simple Example – Part 1:*** Assume Alan, a California resident, has interest income of $500,000 that is taxable at a 35% federal rate and a 12.3% California rate. If A can take an itemized deduction for his California state income taxes, the combined effective tax rate on the interest income is roughly 43%,[1] resulting in total income tax of $215,000. Without the deduction, the total income tax is $236,500, based on a combined effective tax rate of 47.3%, resulting in over $20,000 of additional tax.

Accordingly, approaches that facilitate state tax planning like incomplete non-grantor trusts ("**ING trusts**") may become more appealing. ING trusts refer to any ***incomplete gift*** trust established in a state that generally does not subject the income and capital gains of a non-grantor trust to state income tax (like Delaware or Nevada).[2] Depending on the laws of the grantor's residence and the ING trust's domicile, neither state may tax the ING trust's income (federal income taxes will still apply, however, at rates applicable to non-grantor trusts).

> ***Simple Example – Part 2:*** If Alan creates an ING trust to hold the interest-generating asset and the trust income is not taxable in California, then only $175,000 of federal income tax would apply, assuming a 35% federal rate.

ING trusts may appeal to individuals who expect a significant income generating event or hold high-income producing assets and reside in a state with higher income tax rates that will not tax a non-grantor trust resident in an ING state.[3]

<u>Estate/GST Taxes: The Long Game</u>. Although very speculative at this point, if repeal of the estate and GST taxes were to occur and sunset in 10 years, with grandfathering for planning enacted during repeal, then legacy planning will still remain important and offer substantial opportunities, including:

1. ***Trusts***. Funding irrevocable, multi-generation dynasty trusts with significant assets would preserve those assets from estate and GST tax after any repeal period. The trust creators ("**grantors**") could fund the trust with their remaining gift tax exemptions if the gift tax remains in effect, and using trusts treated as grantor trusts for federal income tax purposes would allow further non-gift transfers to the trust through the grantor's payment of the trust's income tax liability. Further, regardless of tax changes, trusts will remain important as customizable, multi-purpose planning vehicles that provide control, ***creditor protection*** (a key concern for many families), flexibility, family support, and wealth stewardship over multiple generations.

2. ***Installment Sales, GRATs, SLATS***. Grantors could use installment sales to grantor trusts to transfer additional value to dynasty trusts without generating income recognition, according to longstanding and appropriate tax principles. Zeroed-out GRATs designed to terminate before a repeal's expiration offer another funding alternative, if the estate and GST tax do not apply at a GRAT's termination. Both approaches produce low to no gifts at creation and only transfer asset appreciation to the beneficiaries, while providing the grantor with a fixed annual income stream and the return of the initial principal transferred. Including a spouse as a current trust beneficiary (as in spousal lifetime access trusts, "**SLATs**") also allows a family to benefit from the trust if needed.

3. ***ILITs***. The use of ILITs will remain important in life insurance planning, and product selection will be a key component in ensuring flexibility. For example, acquisition of a convertible, level term policy can capture insurability now while preserving future planning options for the trustee and insured. To further increase flexibility, monthly rather than annual premiums payments also can be used, as well as return of premium riders, which return premiums to policy owners if they decide to cancel the policy.

<u>Business Planning: A Sea Change</u>. Changes in tax rates applicable to corporate and pass-through business income may open up some new planning opportunities with regard to entity selection and the creation of business structures:

1. ***C Corporations***. C corporations may become more popular with the reduced corporate tax rate and elimination of the AMT.

2. ***Pass-Through Business Entities.*** The lowering of the pass-through business income tax rate from 39.6% to 25% would have a meaningful effect on business entity selection. As a simple example, in terms of dollars, this reduction could provide a pass-through business owner with up to $73,000 in tax savings on $500,000 of pass-through income.

Depending on the specific legislation and its definition of "business," investors and entrepreneurs may need to reorganize pass-through entity structures for various investment/business endeavors to take advantage of a lower rate on pass-through business income.

3. ***Split-Dollar.*** Business split-dollar insurance arrangements may become more appealing, as benefits provided to the insured employee/owner would be taxed at lower income tax rates.

AALU ACTIVITY

AALU continues to educate Members about the benefits of life insurance products and the negative impacts of the Camp Draft, including changes to the current and appropriate tax treatment of life insurance products for both individual and business uses. Given all the uncertainty, we are constantly monitoring the Congressional environment, and have a number of meetings underway with our Ambassadors and policymakers. We will continue to advocate for our core issues: 1) Continuation of Today's Responsible and Appropriate Tax Treatment of Life Insurance Products for both Individual and Business Uses 2) Permanence and Certainty for Effective, Long-Term Estate Planning, and 3) a Tax Code that Equitably Treats All Businesses, Regardless of Size or Structure.

TAKE-AWAYS

Change can bring opportunities. Families and advisors should remain consistent in their approach to implementing flexible life insurance and legacy planning, since much of this planning will remain beneficial even with tax reform. While enactment of tax reform legislation before year-end is ambitious, families should still consult with advisors sooner rather than later to review their current tax exposure and run scenarios regarding the timing of various items of income, gains, deductions, etc. This will allow families to hit the ground running and avoid a year-end "crunch" should tax reform move on a fast track.

NOTES

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.

[1] Calculated as follows: [(100%-35%) x 13.3%] + 35% = 43.6%.

[2] Note that whether a state does or does not impose tax on a particular trust will depend on the circumstance of the grantor and the trust, as well as applicable state law.
[3] Note that a multitude of factors may affect the final state tax analysis, including the domicile of the grantor at the trust's creation or when it became irrevocable, whether the trust is an *inter vivos* or testamentary trust, the residence of trust beneficiaries, the location of the administration or property of the trust, etc. As the analysis is highly state specific, local counsel both in the grantor's state and in the contemplated ING State should be consulted to review the potential state income tax consequences prior to implementation of any ING trust.