



# Marketplace

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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.

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**TOPIC:** 2015 Year-End Wealth Transfer Planning: Where We Are, What's Coming, & What to Do Now.

**MARKET TREND:** Changes to market conditions and certain tax rules appear to be on the horizon, making it important to manage the future.

**SYNOPSIS:** For now, it seems income and gift/estate tax rates will stay much the same for 2016, but what is trending ahead? Interest rates are low, but market conditions are creating pressures to raise rates -- the stock market continues to head upward (even with intermittent volatility), the real estate market appears strong, and there is a fair amount of activity in mergers and acquisitions. The IRS, however, seems poised to regulate the valuation of family limited partnership ("FLP") transfers and continues to keep grantor trust sale transactions on its radar screen. States also appear to be getting more aggressive on tax collections, particularly with regard to trusts. Thus, these conditions all suggest taking an early and proactive approach to wealth transfer planning.

**TAKE-AWAYS:**

(1) Before year-end, clients should close pending FLP transactions and consider implementing estate freezes to take advantage of current market conditions, as even

modest rate increases could change the economics of these transactions. Implementation, however, should be balanced with basis step-up planning to address income and capital gains taxes.

(2) Life insurance continues to play a fundamental role in planning because it can offer (a) policy growth and access to policy cash value that is not subject to current income, capital gains, or net investment income tax under appropriate and long-standing tax laws and principles and (b) a predictable source of estate liquidity that facilitates estate asset retention and basis management.

(3) Life insurance also protects against the grantor's mortality risk in transactions like GRATs and installment sales to grantor trusts, which have proliferated in current market conditions.

(4) If interest rates rise, it will be important to monitor policy crediting rates to see if they will provide competitive internal rates of return relative to other assets.

**PRIOR REPORTS:** 15-38; 15-36; 15-34; 15-31; 15-23; 15-09; 15-05; 14-08.

As year-end quickly approaches, clients inevitably are seeking last-minute advice to help address their 2015 taxes and proactively plan for potential 2016 challenges. This is an ideal time for advisors and clients to review income and wealth transfer plans before possible changes to existing market conditions and tax laws occur.

### ***WHERE WE ARE: CURRENT ENVIRONMENT***

**Taxes.** 2016 federal tax rates, thresholds, and exemptions will remain largely unchanged.<sup>1</sup> Further, the federal gift/estate and generation-skipping transfer (GST) tax exemptions will **only increase by \$20,000**, from \$5.43 million to \$5.45 million in 2016.<sup>2</sup>

**Markets.** The overall economy has rebounded significantly since 2008. The stock market continues to trend upward, the real estate market appears strong, and there has been solid mergers and acquisition activity. Interest rates, however, remain at historical lows (at least for now), and the stock market continues to experience intermittent volatility due to sporadic turmoil in the global markets, which creates periodic opportunities to transfer assets at lower values during down cycles.

### ***WHAT'S COMING: 2016***

**Potentially Higher Rates.** This long-lasting low rate environment has benefited "estate freezes", like grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), intra-family loans (including split-dollar loans) and installment sales, which transfer appreciation in an asset above a federally-set interest (or "hurdle") rate to

family members or trusts. With historically low rates, there is a greater chance that an asset's growth or dividend yield will exceed the applicable hurdle rate (e.g., Applicable Federal Rate or Internal Revenue Code ("Code") §7520 rate), allowing the estate freeze to transfer more appreciation to the beneficiaries (see *WR Marketplace No. 15-34* for a greater discussion of estate freezes and low rate planning). Despite recent economic volatility, however, ***the Federal Reserve continues to indicate its intention to raise interest rates in the near future, which would change the economics of many estate freezes.***

***Example:*** John sets up a 5-year GRAT at the November 2015 7520 rate of 2.0% and transfers \$5 million in appreciating assets to it. The annuity payments to John will increase annually by 20%. The present value of the total annuity payments to John will equal \$5 million (i.e., a zeroed-out GRAT), so there is no taxable gift upon transfer to the GRAT. The average annual growth on the trust assets over the 5-year term is 6%, leaving over \$794,000 to the remainder beneficiaries. Note that if ***the 7520 rate increases by just 0.6%, to 2.6%, the amount passing to the beneficiaries is reduced by almost \$115,000.***

For intra-family loans (including split-dollar loans) or installment sales, concern over pending rate increases could lead to the use of longer-term notes to lock-in lower rates, rather than relying on shorter terms and periodic re-financings. Further, higher rates may enhance the appeal of the economic benefit regime over loans for certain split-dollar arrangements.

**Continued Focus on Grantor Trust Sale Transactions.** Sale transactions with grantor trusts, like installment sales and self-canceling installment notes ("SCINs"), have been consistently used in legacy planning, with the purchase of life insurance in the trusts often used to complement the overall plan. In recent internal guidance and estate tax cases (e.g., the *Woelbing* cases<sup>3</sup>), however, the IRS has challenged some generally accepted approaches to these transactions, including the valuation of the assets sold, the grantor's expectation of repayment, and the trust's ability to fund the repayment. The Administration's recent budget proposals also have targeted sale transactions with grantor trusts<sup>4</sup> (see *WRMarketplace Nos. 15-09 and 14-13*). Thus, ***the IRS's increased focus on grantor trust sale transactions is likely to continue.*** Note that higher interest rates could draw additional attention to certain features of these transactions, such as the trust's ability to meet its obligation under a higher-rate note.

**Proposed Regulations on FLPs and Valuation Discounts.** Family limited partnerships and LLCs ("FLPs") have proliferated over the years, with families using them for many practical purposes, including centralized fiscal management, asset/ownership

consolidation, development of a coherent family investment philosophy, confidentiality, and creditor protection for family members.

Intra-family transfers of interests in these FLPs often generate valuation discounts, which can impact the overall economic performance of many wealth transfer plans, like gifts, GRATs, installment sales to grantor trusts, SCINs, etc. As much of this planning also is done in tandem with the purchase of life insurance, the projected economics can impact the funds available for premiums, especially in larger purchases.

**Example:** John owns a FLP funded with marketable investments valued at \$10 million. John sells a 20% FLP interest to a grantor trust in exchange for an interest-only installment note with a 20-year term, bearing annual interest at 2.57%. The trust anticipates a 5% annual return and plans to use the remaining annual income (after note interest payments) to acquire life insurance. Compare the benefits if no discount applies to the FLP interests sold versus a 25% discount.

Compare	No Discount	25% Discount	Difference
Value of 20% FLP Interest	\$2,000,000	\$1,500,000	+\$500,000
Initial Amount Remaining for Premiums after Debt Service	\$48,600	\$61,450	+\$12,850
Trust Balance After Note Term	\$1,607,000	\$2,532,000	+\$925,000

For some time now, the IRS has scrutinized FLPs funded mostly with passive, marketable securities and used primarily, in its view, as wealth transfer vehicles. The IRS has been working on proposed regulations that could severely limit the use of discounts with these FLPs, and while the actual scope of the regulations is unclear, they may be released soon.<sup>5</sup> **Thus, proposed regulations appear imminent and could limit many planning techniques involving transfers of FLP interests** (see *WRMarketplace* No. 15-23).

**Balancing Act: On-Going Emphasis on Income Tax Issues.** The narrow gap between the top federal income tax and transfer tax rates, combined with higher estate tax exemptions and greater opportunities for basis step-up at death, will continue to make estate planning and income tax planning synonymous concepts for many clients, especially for those in states with higher state tax rates or community property rules (which can impact basis step-up planning, see *WRMarketplace* No. 14-28). **Focus will remain on income tax issues in legacy planning, particularly as they impact lifetime wealth transfers and trust structuring, investment, and distribution management.**

Added emphasis also will be placed on analyzing state tax considerations, particularly for trusts, as many states such as 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*).

### **WHAT TO DO NOW: YEAR-END**

**Close FLP Transactions ASAP.** Despite the speculation, it appears that proposed regulations affecting transfers of FLP interests are coming. Valuation discounts for interests in FLPs, particularly those holding marketable securities, could be severely restricted, potentially affecting proposed transaction economics and reducing the use of FLPs in wealth transfer planning and/or their ability to support life insurance acquisitions. To fall under any possible “grandfathering” provisions, individuals already engaged in transfer planning with FLPs may want to complete the process as soon as possible.

**Implement Estate Freezes Soon.** As even modest increases in interest rates could adversely impact many estate freezes for wealth transfer purposes, clients contemplating this planning should act before the Federal Reserve does.

**Proceed with Caution.** With the recent IRS attention to grantor trust transactions, advisors and clients should always ensure proper documentation, implementation, and administration of these transactions (as with any transaction) (see *WRMarketplace No. 15-09* for a discussion of planning consideration for grantor trust sale transactions and *WRMarketplace No. 14-08* for a discussion relating to GRATs). Incorporating life insurance into the plan can offer additional liquidity upon the grantor’s death, which also can ease concerns if federal tax payments unexpectedly arise.

**Factor in Income Tax Issues.** Legacy planning will need to strike the right balance between income and estate tax goals. Any reductions in estate value from transferring assets, particularly highly appreciated assets, out of the estate must be balanced against the loss of a basis step-up. To achieve optimum results, planning must: (1) analyze both state and federal income and estate tax laws, (2) facilitate basis management, (3) preserve estate tax exemptions, and (4) maximize flexibility. Life insurance proceeds held outside of the insured’s estate, such as in an irrevocable life insurance trust, can address many of these goals by providing liquidity for estate taxes and allowing highly-appreciated assets retained in the insured’s estate to achieve a basis step-up.

When implementing trust planning, clients also should consider the income tax status of the trusts they create, whether as grantor trusts or a non-grantor trusts. With grantor trusts, the grantor pays the income tax on the trust's income, which allows the trust assets to grow without reduction for the liability. In contrast, non-grantor trusts reach the highest income tax rate (39.6%) and are subject to the 3.8% net investment income tax with income of just \$12,300 (\$12,400 for 2016), unless that income is distributed to the beneficiaries (which could be problematic if beneficiaries are unaware of the trust or have creditor or other issues). For existing trusts, trustees may need to alter the trust's investment strategies to meet their fiduciary duty to manage the impact of taxes. Higher income tax rates necessitate closer attention to asset allocations and investment diversification (income versus growth, taxable versus tax exempt, timing of gains and losses), including the consideration of the purchase of life insurance.

Before year-end, trustees of non-grantor trusts also 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*). Further, the trustees should analyze the trust's potential state tax exposure in multiple states due to the location of trustees, trust assets, and/or trust beneficiaries, and whether changes in the location of trust administration, the trustees and/or decanting the trust can minimize the liability (see *WRMarketplace No. 15-38*).

### ***LIFE INSURANCE – STILL FUNDAMENTAL***

Life insurance continues to play an important role for clients for the rest of 2015 and throughout 2016. Growth that remains within the policy is not subject to current income, capital gains or net investment income tax under appropriate and long-standing tax laws and principles. This is especially important for clients in states that also impose high income tax rates. Further, if the policy is not a modified endowment contract, the policy owner can access cash value up to the owner's basis in the policy without current income tax.

As noted, for estate tax purposes, life insurance can facilitate estate liquidity and basis management. Life insurance also can provide protection for freeze planning that is highly dependent on the grantor's mortality/longevity (e.g., GRAT, QPRT, installment sale to grantor trust, etc.).

Many permanent life insurance products also have components that can serve as a flexible way to diversify an individual's or trust's portfolio. The death benefits can provide an immediate and substantial source of liquid assets at a predictable value, a

feature not found in many other assets. Further, depending on the policy, the owner 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. Many policies, however, have seen their crediting rates adjusted to reflect the current low rate environment. If interest rates rise, it will be important to monitor these policy crediting rates to see if they will provide competitive internal rates of return relative to other assets.

## **TAKE-AWAYS**

- Before year-end, clients should close pending FLP transactions and consider implementing estate freezes to take advantage of current market conditions, as even modest rate increases could change the economics of these transactions. Implementation, however, should be balanced with basis step-up planning to address income and capital gains taxes.
- Life insurance continues to play a fundamental role in planning because it can offer (a) policy growth and access to policy cash value that is not subject to current income, capital gains, or net investment income tax under appropriate and long-standing tax laws and principles and (b) a predictable source of estate liquidity that facilitates estate asset retention and basis management.
- Life insurance also protects against the grantor's mortality risk in transactions like GRATs and installment sales to grantor trusts, which have proliferated in current market conditions.
- If interest rates rise, it will be important to monitor policy crediting rates to see if they will provide competitive internal rates of return relative to other assets.

## **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

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<sup>1</sup> E.g., top individual income tax rate of 39.6%, long-term capital gains rate of 20% and transfer tax rate of 40%.

<sup>2</sup> Note that while federal tax rates and exemptions remain largely unchanged, advisors should always review and confirm the impact of any state tax changes for clients when implementing planning.

<sup>3</sup> *Estate of Marion Woelbing v. Commissioner* (T.C. No. 30260-13) and *Estate of Donald Woelbing v. Commissioner* (T.C. No. 30261-13).

<sup>4</sup> See *WRMarketplace No. 13-16* for a discussion of the grantor trust proposal contained in the Obama Administration's revenue proposals for fiscal year 2014.

<sup>5</sup> As to the scope of the proposed regulations, although there has been discussion that the proposed regulation would be based on a proposal included in the Obama Administration's revenue proposals for fiscal year 2013 (see *WRMarketplace No. 15-23* for a summary of that proposal), according to reported comments of Leslie Finlow, an IRS senior technician reviewer, to the American Institute of CPAs Fall Tax Division Meeting, the guidance won't be based on previous administration proposals but will focus on "the statute [Code §2704(b)] as it looks now." See Diana Freda, "Forget That 2013 Obama Proposal on Valuation Discounts," *Bloomberg BNA Daily Tax RealTime*, posted November 04, 2015.

With regard to timing, reported comments made on September 18, 2015 by Catherine V. Hughes, estate and gift tax attorney-adviser in Treasury's Office of Tax Policy, state that the IRS is "getting closer" but that she could not estimate when the proposed regulations would be out. See Alison Bennett, "Guidance on Valuation Discounts 'Getting Closer'," *BloombergBNA Daily Tax Report*, September 18, 2015. Further, Leslie Finlow, IRS senior technician reviewer, reported stated to the American Institute of CPAs at their Fall Tax Division Meeting that the guidance is expected "very soon." See Diana Freda, "Forget That 2013 Obama Proposal on Valuation Discounts," at Note 4.