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TOPIC: The Winds of Change Are Blowing – What's on the Horizon?

MARKET TREND: As both the Department of Labor and the IRS focus on areas impacting the life insurance industry, 2016 could be an eventful year.

SYNOPSIS: The life insurance industry could soon be in for some watershed changes, as indicated by the Department of Labor's ("DOL") proposed fiduciary rule, the IRS's 2015-2016 Priority Guidance Plan, and the General Explanations of the Administration's FY 2016 Revenue Proposals ("FY 2016 Greenbook"), which contains numerous proposals to modify certain rules and reporting requirements impacting the retirement planning market in a potentially wholesale manner, as well as wealth transfer approaches that use life insurance to effectively plan.

TAKE AWAYS: From the DOL's perspective, the fiduciary rule is a reaction to its perceived need for additional protection for pension and retirement plan beneficiaries, but the rule could actually limit the availability and/or increase the cost of investment advice for average retirement savers. The question is whether this could be a first step in a broader plan for increasing the federal regulation of the sale of insurance-based products. With regard to the IRS and Greenbook proposals, these are reactions to the proliferation in estate planning activity with respect to GRATs, installment sales to grantor trusts, and private placement vehicles for life insurance and annuity planning resulting from the current market and tax environment, specifically: (1) low interest rates, (2) higher income tax rates, and (3) convergence of the top transfer and income tax rates. Query whether the IRS is seeking to limit wealth transfers to simply the federal exemptions.

PRIOR REPORTS: 15-45; 15-23; 15-20; 15-05.

MAJOR REFERENCE: (1) DOL Proposed Definition of the Term "Fiduciary," Conflict of Interest Rule - Retirement Investment Advice; (2) DOL Proposed Best Interest Contract Exemption; (3) DOL Proposed Amendment to and Proposed Partial Revocation of Prohibited Transaction Exemption (PTE) 84–24; (4) General Explanations of the Administration's FY 2016 Revenue Proposals Department of the Treasury 2015-2016 Priority Guidance Plan; (5) First Quarter Update (Oct. 23, 2015, "Priority Guidance Plan").

With both the DOL and the IRS lightening-focused on areas impacting the life insurance industry, 2016 could be an eventful year for advisors. The following summarizes notable developments that may be coming soon.

1. DOL PROPOSED FIDUCIARY RULE & PRACTICAL IMPLICATIONS

As fully discussed in *WRMarketplace #15-20*, the Department of Labor ("**DOL**") has proposed a greatly expanded version of ERISA's definition of "fiduciary" for advisers who provide investment advice to plan participants, IRA owners, and plan sponsors of small qualified plans (i.e., less than 100 participants). The following summarizes notable points and implications.

Definition of Fiduciary. The proposed regulation broadly defines a fiduciary ("**investment advice fiduciary**") as a person who meets the requirements below (with limited exceptions):[1]

- *Advises Covered Investors.* The person provides investment advice to any specified retirement plans, their fiduciaries or participants or even any IRA owners.

- *Provides Investment Advice*. The advisor provides any of the following investment advice:

  - Makes investment recommendations, including recommendations to take distributions, or how to invest the distributions or rollovers, from a plan or IRA;
  - Makes investment management recommendations, including on assets to be rolled over or distributed from a plan or IRA;
  - Provides asset appraisals or similar valuation statements (verbal or written) in connection with the plan's or IRA's acquisition, disposition, or exchange of such assets; ***or***

- Recommends another person who also will receive a fee or other compensation for providing any advice above.

- *Receives Compensation.* Receives, directly or indirectly, a fee or other compensation for the advice (including brokerage fees, mutual fund sales, and ***insurance sales commissions***).

- *Makes Representations or Agreements.* Either, directly or indirectly: (1) represents or acknowledges that he is acting as a fiduciary under ERISA with respect to the advice; **or** (2) renders advice per a written or verbal agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient for consideration in making investment or management decisions with respect to plan or IRA assets.

"Conflicted-Interest" Compensation Prohibited. The rule prevents, as a prohibited transaction, investment advice fiduciaries from receiving "conflicted-interest" compensation for investment advice, ***including commissions or revenue-shares***, unless an exemption applies.

New Proposed "Best Interest Contract Exemption" (BICE). The rule proposes a new exception, the BICE, which would allow advisers and financial institutions (and affiliates and related entities, collectively "**advisers**") to receive otherwise prohibited compensation for advice to a plan participant or beneficiary, the beneficial owner of an IRA, or a plan sponsor of a small qualified plan who holds plan investment authority (collectively, "**Retirement Investors**").[2]

- *Significant & Complex Requirements.* Taking advantage of BICE requires advisers to comply with several, complex requirements ***before providing the advice***, primarily through execution of a written contract and other disclosures, ***just a few of which are summarized below*** (see WRM #15-20 for a full discussion of BICE requirements):

  - Acknowledge Fiduciary Status. Parties must agree that the adviser is a fiduciary under ERISA or the Internal Revenue Code ("**Code**").

  - Compliance with Impartial Conduct Standards. The adviser must agree to, and comply with, "impartial conduct standards" when rendering the advice, including that the investment advice will not recommend an asset if the total amount of anticipated compensation to the adviser will exceed reasonable compensation for the total services they provide to the Retirement Investor.[3]

- Provision of Warranties. The BICE requires several warranties in the adviser's contract.[4] ***These warranties are significant and substantial, and just a few are noted below (see WRM#15-20 for a full list)***:

  - *Compensation Structures.* The advisers must warrant that they ***will not use quotas, appraisals, performance, bonuses or other differentiated compensation or incentives*** that tend to encourage individual advisers to make recommendations not in the Retirement Investor's best interest.[5]

  - *Contractual Disclosures*. These include disclosing in writing to the Retirement Investor all material conflicts of interest, the right to obtain complete information about all fees associated with the investments, and disclosing whether the financial institution offers proprietary products or receives third party payments with respect to the purchase, sale or holding of any asset. ***Failure to include all the required disclosures vitiates reliance on the BICE.***

  - *Per-Transaction and Annual Disclosures*. Before executing a purchase, the adviser must give the Retirement Investor a chart that provides, for each asset recommended, the total cost to the plan, participant or beneficiary account or IRA of investing in the asset for one-, five- and ten-year periods, and the adviser must provide the Retirement Investor, within 45 days after each year-end, a disclosure listing each asset bought or sold during the year, the purchase or sale price, the total of all fees and expenses paid with respect to each such asset, and a statement of the total compensation received by the adviser directly or indirectly from any party as a result of each such asset.

  - *Notice to DOL*. Advisers wishing to rely on the BICE must notify the DOL of their desire to do so ***before receiving the exempt compensation***.

  - *Data Retention, Requests and Recordkeeping*. Advisers must agree to retain documents and data relating to investment recommendations. Specifically, ***for a 6-year period***, the adviser must maintain records of inflows, outflows, holdings and returns to satisfy requests for examination by the DOL, the IRS, a Retirement Investor or any employer plan sponsor that engaged in a transaction under the BICE.

Modification & Partial Revocation of Insurance & Annuity Contract Exemption. The DOL also proposes to modify the ***compensation exemption for purchases by ERISA plans and IRAs of insurance and annuity contracts and for the receipt by an***

insurance agent, broker, pension consultant or other fiduciary to a plan or IRA of a sales commission for those purchases.

- Variable Annuities & Contracts - Federal Securities. The DOL would revoke the current exemption and create a supplemental exemption to the BICE[6] for IRA purchases of variable annuities and other contracts that are federal securities, which would require:

  - The transaction be effected by the insurer in the ordinary course of its business.
  - The combined total of all fees and compensation received by the insurer not exceed reasonable compensation under the circumstances.
  - The purchase is for cash only, and the terms are at least as favorable to the plan as the terms generally available in an arm's length transaction with an unrelated party.

- Insurance, Annuity & Other Contracts - Not Federal Securities. For purchases of insurance and annuity contracts that are not securities, the DOL would modify the current compensation exemption to require that, if the insurance agent, broker, pension consultant, insurance company or investment company principal underwriter ("**insurance advisor**") is an investment adviser, the insurance advisor must ***comply with impartial conduct standards similar to those under the BICE to fall under this exemption***.

  - The insurance advisor does not need to enter into the same pre-sale contractual agreement with all the BICE provisions and warranties ***but still must provide certain written disclosures to the plan fiduciary, who must, before the transaction, acknowledge, in writing, receipt of the disclosures and approval for the transaction***.

  - The disclosures include: (1) any limitations on the products recommended by the insurance advisor if he is an affiliate of the carrier issuing the recommended contract, (2) the commission the insurance advisor will receive, expressed as a percentage of the gross annual premium payments, and (3) a description of any charges, fees, discounts, penalties, etc. that may be imposed under the recommended contract in connection with its purchase, holding, exchange, termination or sale.

PRACTICAL IMPACT. The proposed rules and revisions to prohibited transaction compensation exemptions would significantly impact commission-based compensation for advisers and may be viewed as a first step toward greater federal regulation of the insurance and annuity markets.

- Compensation structures involving differentiated commissions and incentives are prevalent throughout the insurance industry, making it difficult to know exactly what forms will violate the DOL's standard. States (e.g., New York) also have positions on this issue.

- Thus, taking advantage of the BICE would likely require a wholesale re-evaluation of, and significant changes to, compensation models for insurers and financial institutions. Implementation of the BICE's recommended policies, as well as the data and recordkeeping requirements and pre-transaction and annual disclosure requirements, also would likely impose enormous burdens on those companies to establish and administer new systems for monitoring producer activities and/or maintaining data files not kept under their current systems.

- The BICE also causes advisers dealing with IRAs (which are not covered by ERISA) to subject themselves contractually to ERISA-like standards of conduct, thereby creating a private cause of action on behalf of IRA owners to seek a remedy for a breach.

- For the DOL, this is a reaction to its perceived need for more protection for pension and retirement plan beneficiaries, but, given the above, ***the approach could actually increase the cost of investment advice for average retirement savers, as advisers and financial institutions pass on the significant administrative costs***. Alternatively, as the business becomes more regulated, with increased liability, ***service provides may exit the market, meaning fewer investment advice options for consumers.***

2. IRS PRIORITY GUIDANCE PLAN – FOCUS ON GRANTOR TRUSTS

As discussed in *WRMarketplace #15-45*, the IRS continues to focus on estate planning involving grantor trusts, adding the following items to its 2016 Priority Guidance Plan:

- **Basis of Grantor Trust Assets at Death**. Whether assets in a grantor trust take a carry-over basis or receive a basis step-up at the grantor's death. This issue often arises in installment sales to grantor trusts, where there also is debate regarding the tax treatment at the grantor's death if the note remains outstanding, including whether gain recognition is triggered from the sale at the grantor's death due to termination of grantor trust status.

- **Valuation of Promissory Notes for Transfer Tax Purposes**. Whether promissory notes in intra-family loans/sales charge adequate interest (e.g. at the applicable federal rate (**AFR**)) and provide fair market value for the assets sold. The note's value is a key component of determining the gift, estate, and GST tax treatment of these transactions.[7]

- **Gift Tax Effects of Defined Value Formula Clauses**. These clauses are used to make gifts or sales of difficult-to-value assets and minimize concerns about later IRS adjustments to the value of the assets transferred and often are used with transfers to grantor trusts. The U.S. Tax Court, in *Wandry v. Commissioner*, upheld the use of a simple formula transfer clause involving gifts of interests in a family-owned entity, but the IRS did **not** acquiesce.

- **Family Limited Partnership (FLP) Guidance Still Pending**. As discussed in *WRMarketplace #15-23*, it appears the IRS could soon issue proposed regulations that could severely limit the use of discounts with FLPs primarily invested in marketable securities, thus limiting planning that involves transfers of these FLP interests (often to grantor trusts).

PRACTICAL IMPACT. The above items indicate that the ***IRS is taking a "global" approach to guidance on grantor trusts and related transactions that could potentially severely restrict their use, effectively limiting wealth transfer planning to the use of the federal transfer tax exemptions.*** Depending on the scope of this guidance, it could dramatically alter the form and economics of estate and life insurance plans, since grantor trusts are staples in such planning.

3. FY2016 GREENBOOK PROPOSALS

As discussed in *WRMarketplace #15-05*, the FY2016 Greenbook contained several proposals related to life insurance, individual, and transfer tax reform, including:

Notable Life Insurance Proposals

- *Expand Interest Deduction Limits for Corporate-Owned Life Insurance (**COLI**) Policies.* Currently, corporations cannot deduct interest on loans to buy or carry life insurance on any individual—subject to a *de minimus* key person exception. There also is a pro-rata limit on interest deductions related to un-borrowed cash values of policies covering individuals other than someone who, when first insured, was an officer, director, employee or 20% owner. The proposal ***limits the exclusion of COLI policies to only those insuring 20% owners***.

    - ***PRACTICAL IMPACT***. This proposal operates as a tax penalty to businesses owning life insurance by indirectly taxing the inside build-up of COLI policies and increasing the business costs of buying cash value policies on key employees, officers, and directors.

- *Limit Exceptions to Transfer for Value (**TFV**) Rule for Life Settlements.* Currently, death benefits paid under a policy transferred for value are subject to income tax on the proceeds in excess of the consideration and premiums paid by the purchaser. This rule does not apply to certain policy transfers, including a policy transfer to a partner of the insured or to a partnership or corporation in which the insured is a partner or a shareholder/officer, respectively.[8] The proposal would allow the above ***exceptions to apply only if the insured was a 20% owner of the partnership or corporation***.
    - ***PRACTICAL IMPACT***. The potential for an overly-broad application of this proposal could result in the taxation of common business transactions, such as business-related policy transfers (as in corporate mergers or acquisitions) and roll-outs of split dollar arrangements to former employees or owners, buy-sell restructurings.

- *New Information Reporting for Private Separate Accounts.* This proposal requires life insurers to report to the IRS, for each policy with cash value invested in a private separate account that represents at least 10% of the account value for the taxable year, (1) the policy holder's identity, (2) the policy number, (3) the accumulated, untaxed income, (4) the total contract value, and (5) the portion of the account invested in a private separate account.
    - ***PRACTICAL IMPACT***. The proposal would allow the IRS to more closely evaluate private placement variable contracts and determine if they should be disregarded as insurance contracts because the owners have retained too much investment control.

Notable Transfer Tax Reform Proposals. These include:

- *Trigger Capital Gains Tax on Gifts/Bequests of Appreciated Assets.* Currently, gifted or bequeathed assets do not trigger income or capital gains tax and generally take a carry-over basis in the hands of the recipient, according to appropriate and longstanding tax principles. The proposal ***treats gifts and bequests of appreciated assets as sales for capital gains tax purposes and triggers capital gains tax on the appreciation in the year of transfer***, with the realized capital gain taxable to the donor or decedent's estate (with some exemptions, such as for transfers to spouses and charities).
    - ***PRACTICAL IMPACT***. This proposal would dramatically increase the overall tax burden of gifts/bequests and create significant liquidity issues for donees and estates. The liability could be exacerbated by state income or capital gains

taxes. This may limit lifetime gift planning, but enhance the needs for life insurance at death.

- *Transfer Tax Changes to Grantor & Dynasty Trusts.* The proposals: (1) impose a 10-year minimum term and a minimum remainder of the greater of 25% or $500,000 for GRATs, (2) impose a 90-year limit on a trust's GST tax exemption, and (3) coordinate income and estate tax rules for grantor trusts, so that disregarded transactions between a grantor trust and its grantor for income tax purposes incur an estate tax (at the deemed owner's death) or a gift tax (upon a trust distribution or at termination of grantor trust status).
    - ***PRACTICAL IMPACT***. These proposals would generally make the economics of grantor trust and GRAT planning, both of which use life insurance to plan effectively, far less attractive.

TAKE-AWAYS

- From the DOL's perspective, the fiduciary rule is a reaction to its perceived need for additional protection for pension and retirement plan beneficiaries, but the rule could actually limit the availability and/or increase the cost of investment advice for average retirement savers. The question is whether this could be a first step in a broader plan for increasing the federal regulation of the sale of insurance-based products.
- With regard to the IRS and Greenbook proposals, these are reactions to the proliferation in estate planning activity with respect to GRATs, installment sales to grantor trusts, and private placement vehicles for life insurance and annuity planning resulting from the current market and tax environment, specifically: (1) low interest rates, (2) higher income tax rates, and (3) convergence of the top transfer and income tax rates. Query whether the IRS is seeking to limit wealth transfers to simply the federal transfer tax exemption amounts.
- AALU will continue to engage Congress and the DOL to educate them about the negative impacts of the rule for average retirement savers, in conjunction with our industry partners.

NOTES

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[1] There are seven carve-outs to the definition, which include: (1) certain counterparties to transactions with the plan or IRA, (2) swap and security-based swap transactions, (3) employees of the plan sponsor, (4) providers of investment platforms, (5) selection and monitoring assistance provided pursuant to objective standards, (6) certain financial reports and valuations, including those rendered to employee stock ownership plans, and (7) investment education.

[2] For purposes of the BICE, the proposed regulation specifically defines these terms as follows: (1) an "Adviser" is generally an individual investment advice fiduciary of a plan or IRA who is an employee, independent contractor, agent or registered representative of a "Financial Institution," (2) a "Financial Institution" is a registered investment adviser, bank, insurance company or registered broker-dealer that employs an Adviser; (3) "Assets" are intended to encompass those investments that are needed to build a basic diversified portfolio and include only: bank deposits; certificates of deposit; shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITS, or exchange-traded funds; corporate bonds offered pursuant to a registration statement under the Securities Act of 1933; agency debt securities as defined in FINRA Rule 6710(l) or its successor; U.S. Treasury securities as defined under FINRA Rule 6710(p) or its successor; insurance and annuity contracts; guaranteed investment contracts; and equity securities within the meaning of 17 C.F.R. §230.405 that are exchange-traded securities within the meaning of 17 C.F.R. §242.600, and (4) a "Retirement Investor" may be a plan participant or beneficiary with the authority to direct the investment of assets in his or her account or to take a distribution, the beneficial owner of an IRA, or a plan sponsor of a non-participant-directed ERISA plan that has fewer than 100 participants to the extent that it acts as a fiduciary who has authority to make investment decisions for the Plan.

[3] The other standard include: (1) the investment advice provided will be in the best interest of the Retirement Investor (i.e., advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the adviser, financial institution, or any affiliate, related entity, or other party); and (2) statements about the asset, fees, "material conflicts of interest", and any other matters relevant to a Retirement Investor's investment decisions, will not be misleading.

[4] Note, however, that the BICE's application is not conditioned on compliance with these warranties. Accordingly, while the failure to comply could result in contractual liability for breach of warranty, it would not result in loss of the BICE if the breach did not involve a violation of another BICE condition.

[5] The DOL even suggests (but does not mandate) various examples of acceptable compensation structures: level-fee structure, independently certified computer models, asset-based compensation, fee offsets, etc. It also suggests policies for adviser compensation, which include avoiding the creation of compensation thresholds that enable an adviser to increase compensation disproportionately through an incremental increase in sales and maintaining neutral compensation grids that pay advisers a flat payout percentage regardless of product type sold.

[6] This supplemental compensation exemption applies only to the prohibitions of ERISA §§406(a)(1)(A) and (D) and Code §§4975(c)(1)(A) and (D). For relief from the self-dealing provisions of ERISA §406(b) and Code §§4975(c)(1)(E) and (F), the requirements of the general BICE must be satisfied.

[7] The IRS faces some internal conflict here, as it generally wants to discount the face value of these notes for gift tax purposes, but not for estate tax purposes. It is one of the main issues raised in the *Woelbing v. Commissioner* cases currently pending in the U.S. Tax Court. See *Estate of Marion Woelbing v. Commissioner* (T.C. Docket No. 30260-13) and the *Estate of Donald Woelbing v. Commissioner* (T.C. Docket No. 30261-13). Note that the court ordered the parties to file a joint status report on or before Jan. 29, 2016. Respondents filed their report on Jan. 13, 2016.

[8] Other transfers excluded from the TFV rule are (1) transfers of a policy if the transferee's tax basis is determined by reference to the transferor's basis (e.g., a gift), (2) transfers of a policy to the insured (including the insured's wholly-owned grantor trust). See Code § 101.