



WRMarketplace

An AALU Washington Report

The *WR Marketplace* 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 S. Manicone.**

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TOPIC: Decoding Tax Reform: The Transfer Tax Impact

MARKET TREND: Tax reform will dramatically alter the legacy planning landscape for the next several years and offer a host of new opportunities.

SYNOPSIS: Tax reform legislation (“H.R. 1”) was signed by the President on December 20th, enacting numerous immediate changes affecting all areas of the Internal Revenue Code (“Code”), including changes to gift, estate, and generation-skipping transfer (“GST”) taxes. Effective January 1, 2018, H.R. 1 doubles the base exemption level for the gift/estate and GST tax from \$5 million to \$10 million (as annually adjusted for inflation using a new “chained” index). While almost all other transfer tax provisions remain the same, this single change fundamentally impacts all areas of transfer tax planning at least until 2026 when the doubled exemptions sunsets.

TAKE-AWAYS: H.R. 1 provides new challenges and opportunities in legacy planning. All families should meet with advisors now to revisit their estate and life insurance planning to ensure that it both meets their current needs and is optimally-structured under the new tax laws.

Yet, change can still be a good thing, and there will be continued and unique opportunities for life insurance, legacy, and business succession planning, given the flexibility and freedom provided by the increase in the transfer tax exemptions.

SNAPSHOT COMPARISON: TRANSFER TAX CHANGES

TRANSFER TAXES		
Provision	Current Law	H.R. 1
Rates	40% top rate (flat rate for GST tax)	Same
Gift/Estate & GST Tax Exemptions	\$5 million basic exclusion amount* (\$5.49 million in 2017; scheduled to be \$5.6 million in 2018) for the unified gift/estate and GST tax exemptions.	Doubled basic exclusion amount (\$10 million)* starting 2018 . Expires in <u>2026</u> , when exemptions revert to \$5 million, as inflation adjusted from 2010 to 2026.
Basis Step Up at Death	Yes	Same
Inflation Indexing	Applies the Consumer Price Index for All Urban Consumers (CPI-U).	Applies the “chained” CPI-U (C-CPI-U). Text of H.R. 1 does not specify expiration in 2026.

*Subject to annual inflation indexing.

MINIMAL CHANGES – MAXIMUM IMPACT

While the technical changes to the Code’s transfer tax changes are minimal, the impact is significant. As previously discussed in *WRMarketplace No. 50*, the following provides additional details on the specific changes to the transfer tax exemption and initial comments on how they may impact legacy planning.

The Specifics

- **Doubling of Exemptions.** The Act doubles the “basic exclusion amount” from \$5 million to \$10 million for gift, estate, and GST tax purposes until 2026. This represents the threshold amount that is then annually adjusted for inflation from a base year of 2010 to determine the applicable exemption amount in each year. !
 - **For 2018, the inflation adjusted basic exclusion amount should equal roughly \$11.2 million (\$22.4 million per married couple)**, although the amount may be somewhat less given the new index used for inflation adjustments (see below).

- ***On January 1, 2026, the basic exclusion amount will return to \$5 million, as indexed for inflation from 2010 to 2026.***
- **Slower Inflation Adjustments.** The Act changes the standard used to make inflation adjustments to a “chained” index, the C-CPI-U.² While the difference in growth between the traditional CPI versus the chained CPI is a few tenths of a percentage point, the difference adds up over time. Thus, the change will result in slower and smaller inflationary adjustments in the years after 2017.
 - ***Example:*** Using the traditional CPI, the basic exclusion amount has increased roughly by an average of 1.7% annually, resulting in an inflation-adjusted exclusion amount of over \$6.5 million in 2026. Assuming a 1.5% annual adjustment under the chained CPI, the inflation-adjusted exclusion amount in 2026 would be only around \$6.3 million, about \$200,000 less.
 - ***H.R. 1 does not specifically provide for the sunset of this change,*** meaning the chained CPI may remain the standard for inflation adjustments to the basic exclusion amount and other inflation-indexed amounts.
- **Same Rates.** All transfer tax rates remain the same, with a 40% top rate for the gift and estate taxes and a 40% flat rate for the GST tax.
- **Basis Step-Up.** Estate assets will continue to receive a step-up in income tax basis to their fair market value at a decedent’s passing.
- **No “Clawback” Likely.** The potential for an increase and then drop in the available federal estate tax exemption has previously raised the issue of a so-called “clawback,” which arguably results in greater estate tax liability if lifetime gifts are made using a higher unified gift/estate tax exemption, but the donor later dies when the unified gift/estate tax exclusion has decreased.³ The Act seems to provide a proactive resolution of this issue by giving the IRS authority to prescribe regulations to address any difference between the basic exclusion amount at the time of any gifts by a decedent and the basic exclusion amount at the decedent’s death.⁴ So it appears families should not be overly-concerned about using their full lifetime gift tax exemptions before 2026.
- **Planning Considerations:**
 - Although the federal estate tax appears now to apply to a very small percentage of taxpayers (e.g., far less than 1%), legacy and life insurance planning remains critical for most families. ***There is nothing permanent about these transfer tax changes,*** as they are set to expire in eight years, if they are not changed in the interim under a different Administration.

Failing to plan is at a family's peril, since the success of most legacy planning relies on a disciplined long-term approach that hedges against mortality and preserves insurability, both of which are at risk for those who choose to wait.

- Remember that families with estates below the federal estate tax exemption but who reside in decoupled states with estate tax exemptions lower than the federal estate tax exemption or that have an inheritance tax can still face state tax exposure, and states with estate exemptions tied to the federal amount may reconsider these provisions due to the potential lost revenue.
 - As of 2018, states with a separate estate tax include Connecticut, D.C., Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington. States that impose an inheritance tax include Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania.
- Tax considerations alone should never drive legacy planning, as it also can address critical, practical concerns that many families face, including: (1) centralized wealth management, (2) confidentiality and creditor protection for family members, (3) control of the flow of information and assets to younger beneficiaries, (4) business succession and family governance of shared assets, and (5) asset consolidation to facilitate the transfer of diverse investments among generations without creating fractional ownership.
- Given the above, irrevocable trust planning will remain important, as trusts provide customizable, multi-purpose planning vehicles that offer control, creditor protection, flexibility, family support, and wealth stewardship over multiple generations. The use of irrevocable trusts also ensures that trust assets remain outside of a taxable estate, as the grantor pays the income tax on trust assets, which is particularly important given the lower exemptions in 2026 and the uncertainty around additional estate tax changes before that time. Trusts that offer lifetime benefits to the donor's spouse (i.e., spousal lifetime access trusts or "**SLATs**") can allow the donor to indirectly benefit from a trust during life, if needed.
- Families whose estates are unlikely to exceed the new exemptions could use the higher gift tax exemption to exit existing planning transactions, such as installment sales to grantor trusts or split-dollar arrangements.
- For families who continue to be affected by the federal estate tax, ***the increased and immediately available gift and GST tax exemptions present an exceptional opportunity to implement substantial lifetime planning over the next few years***, particularly dynastic planning through trusts and business succession planning for those with concentrated positions in closely-held businesses.

The use of large gifts to fund life insurance acquisitions also eliminate the administrative hassles of other funding approaches (e.g., annual gifts).

- Making substantial transfers to grantor trusts can provide additional legacy transfer opportunities as the grantor pays the income tax on the trust assets, particularly in high income tax states. The trust assets and the compound growth thereon will still be excluded from the taxable estate when the Act's provisions sunset. Thus, it may make greater sense to lock-in the transfer of appreciation from the estate and manage basis through the approaches discussed below rather than retain assets for a basis step-up.
- Basis-step up is still available for assets held by a decedent, however, and will remain critical. For basis management, trusts can provide the trust creator ("**grantor**") with a power to substitute assets of equivalent value for the trust assets. This allows a grantor to decide, based on current economic conditions and family needs, whether to exchange the low basis assets in the trust for higher basis assets. Any assets held by the grantor after exercise of the power would be eligible for a basis step up in the grantor's estate. Additionally, for flexibility, the trust could provide powers of appointment to return the trust assets to the grantor or another individual if that makes greater sense.
- Estate freeze plans that result in minimal or no taxable gifts and rely on current interest rates for their hurdle rates (e.g., the 7520 rate and the applicable federal rate) can still offer legacy planning benefits without eliminating the ability for basis step-up planning (e.g., zeroed-out GRATs, installment sales to grantor trusts). These approaches:
 - Take advantage of current low interest rates ***that are on the rise***.
 - ***Transfer only future appreciation***, returning the initial value of the transferred assets to the grantor (plus growth at the applicable hurdle rate), so the family does not have to permanently part with a significant portion of their wealth.
 - Allow clients to ***retain a predictable income stream*** from the transferred asset.
 - ***Preserve estate tax exemptions*** for basis step-up planning.

Split-dollar arrangements provide similar benefits and can still make sense for large cases as the arrangements leverage client funds to pay premiums at fairly minimal costs, especially while interest rates remain low.

- Even with tax uncertainty, life insurance will remain prudent for accomplishing multiple legacy plan objectives.

- Personal cash value life insurance may serve 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.
- Life insurance, especially trust-owned, can: (1) minimize family conflicts, (2) allow equalization among active and non-active heirs regarding a family business, and (3) provide long-term wealth and tax management.
- Post-tax reform, growth within a life insurance policy during the insured's life and payment of the policy death benefit upon the insured's passing will still not be subject to income or capital gains tax. Further, a policy owner may be able to access cash value through policy loans or withdrawals (up to the owner's basis in the policy) without current income tax (assuming the policy is not a modified endowment contract). If held in an irrevocable trust, the policy death benefits also should remain outside of the insured's taxable estate.
- Many high cash value life insurance products also can provide diversification in a client's asset allocation, whether held directly or through a trust. For instance, current assumption universal life and whole life products are not directly correlated to stock market performance and typically benefit from a rising interest rate environment. Analyzing a policy's internal rate of return ("**IRR**") relative to life expectancy ("**LE**") for a policy's death benefit, as well as the IRR 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 asset allocation and investment goals.
- Accordingly, given the above and the on-going potential for estate tax changes, clients should not be too quick to eliminate their life insurance coverage. Coverage reviews, however, should be conducted to determine if changes in the type or amount of coverage are needed, or if there are better products to meet the family's goals in light of the new tax laws.
- Most families should revisit their legacy plans to review how changes in the estate and GST tax exemptions could impact their estate distributions, as many plans rely on exemption-based formulas to fund family bequests and trusts. With the enactment of drastically increased exemptions, individuals may want to cap such funding. To address the possibility of further changes in the transfer tax laws, flexibility also should be built into legacy plans, such as: (1) including multiple options in documents regarding distributions, beneficiary powers of appointment, and the apportionment of tax liabilities that are triggered by then-existing tax laws, (2) giving clients powers of substitution over grantor trusts to reacquire low basis assets, (3) including "decanting" provisions that allow trustees to distribute assets to a new trust with different provisions, and (4)

using trust protectors to make various discretionary tax elections or trust modifications.

TAKE-AWAYS

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NOTES

¹ H.R.1, §11061.

² H.R.1, §§11061, 11002.

³ The issue arises due to the fact that determination of the federal estate tax involves a technical calculation that includes in the tentative taxable estate, and then provide a credit for the amount of, gift tax that would have been payable with respect to gifts if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, the applicable statutes do not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty according to some commentators. The resolution would likely specify both the tax rates and the credit amount that should be used in the calculation, if the exclusion amounts differ between the time of the gifts and the time of death.

⁴ The applicable section of §11061 of H.R. 1 specifically reads as follows: “MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS” - The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out [the section increasing the basic exclusion amount] with respect to any difference between (A) the basic exclusion amount under [Code] section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.”