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 S. Manicone.

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TOPIC: A View from the Experts: Select Insights from the 2018 Heckerling Institute on Estate Planning.

MARKET TREND: Planning trends resulting from the Tax Cuts and Jobs Act (the "Tax Act") took center stage at the 2018 Heckerling Institute on Estate Planning.

SYNOPSIS: Presenters at the 2018 Heckerling Institute on Estate Planning identified several enhanced areas of focus for legacy and life insurance planning post tax-reform, including (1) basis adjustment planning, (2) the potential benefits and pitfalls of portability, especially in light of the doubled federal transfer tax exemptions, and (3) the need to review and refresh existing life insurance planning.

TAKE AWAY: The reality of tax reform necessitates a review of existing legacy and life insurance plans for families across net worth levels, whether to prune plans of unneeded provisions, to insert flexibility to ensure desired basis adjustments or available elections, and/or to take advantage of new, temporary transfer tax exemptions.

The following summarizes a few select insights from presenters at the 2018 Heckerling Institute on Estate Planning, reflecting trends in legacy and life insurance planning in the post-tax reform world.

1. THE NEW SEXY: BASIS MANAGEMENT[1]

Overview. Before 2002, when the federal unified gift/estate tax exemption was $675,000, the top federal estate tax rate was 55%, and almost all states imposed a separate estate (but not gift) tax, lifetime gifts were almost an automatic reaction to potential estate tax liability. While the gifted assets typically took a "carry-over" income tax basis and generated taxable gain upon later disposition, the potential estate tax liability was often the greater concern. Fast-forward to 2018, when the gap between income/capital gains taxes and estate taxes has been compressed or eliminated. Now, legacy planning has a renewed focus on preserving an individual's estate tax exemption for maximum basis step-up at passing and triggering the estate tax inclusion of assets to qualify for that step-up.

Planning Solutions. Given the above, families and their advisors should consider the following to address basis management in their legacy plans:

- **Identify Basis Adjustment Potential*.*** Not all assets will receive or benefit from a basis adjustment at death. For example, a basis step-up will not apply to IRAs or other retirement accounts, nor be a concern for cash, stock, or capital assets at a loss, or high-basis stock (if significant future appreciation is unlikely). Alternatively, ensuring a basis step-up will be very important for assets like copyrights, patents, and other creator-owned intellectual property, intangible assets, and artwork, "negative basis" real estate, low basis stock or other capital assets, and various collectibles ("adjustable assets"). Non-adjustable and adjustable assets should be identified to determine which assets make sense for lifetime planning and which assets should be retained or perhaps reacquired to achieve a basis step-up in an individual's estate.

- **Trigger Adjustment in Existing Plans*.*** For adjustable assets held in existing irrevocable trusts, options for achieving a basis step-up for those trust assets include:

    - ***Substitute Assets***. A nonfiduciary power of substitution over a trust triggers grantor trust status, making the grantor liable for the trust's income tax obligations. However, the grantor can exercise this power to substitute cash or high basis assets of equivalent value in exchange for the low basis trust assets that will receive a basis step up in the grantor's estate.

    - ***Purchase Assets***. If the grantor cannot substitute assets, he or she may consider buying the low-basis assets from the trust in exchange for a promissory note (assuming the use of a grantor trust).[2]

    - ***Change Trust Jurisdiction***. A change of trust jurisdiction may trigger estate tax inclusion. For example, if the grantor is a discretionary beneficiary of a trust located in a state with a domestic asset protection statute, moving the trust to a state without such a statute may result in estate inclusion of the trust.

- **Incorporate Adjustment Options into Plans*.*** Families across net worth levels share similar practical concerns when it comes to legacy planning: (1) ensuring responsible and motivated children, (2) preserving their legacy from creditors and other claims, and (3) providing for centralized and experienced financial management. Trusts, whether created during life or at passing, can address these concerns but also should provide opportunities for basis management so that the practical benefits are not inadvertently offset by tax costs. Planning options to achieve this balance include:
  - Giving an independent party the power to grant a limited power of appointment to the trust grantor or general powers of appointment to trust beneficiaries to trigger inclusion of the trust assets in the powerholder's estate.[3]
  - Granting general powers of appointment to beneficiaries (possibly subject to the consent of a non-adverse party or limited to the appointment to creditors only), based on a formula or applicable only to appreciated assets held by the trust.
  - Providing broad discretionary distribution authority to an independent trustee, who can distribute assets to beneficiaries for a basis step-up in their estates.

2. THE DEATH TRAP: PORTABILITY - NOT AS SIMPLE AS IT SEEMS[4]

Federal gift and estate tax exemption portability allows a predeceased spouse's executor to elect to provide the surviving spouse with the deceased spouse's unused gift and estate exemption (the decease spouse's unused exclusion amount, or "DSUE").

Phantom Simplicity. In theory, portability simplifies legacy planning for spouses by eliminating the need to fund a separate trust at the predeceased spouse's passing to preserve his or her federal estate tax exemption. It gives the surviving spouse's estate more bandwidth for the basis step-up planning discussed above, particularly with higher federal estate tax exemptions. Under current regulations, it also appears that the higher estate tax exemption in effect under the Tax Act may be ported and remain available to the surviving spouse after the federal estate tax exemption reverts to $5 million in 2026 (inflation-indexed).

> ***Example:*** Harold passes in 2018 leaving his entire estate to his wife, Wendy. Harold's DSUE is $11.18 million. His executor elects portability for the full amount to his wife, Wendy. Wendy passes in 2026, having used none of Harold's DSUE. Wendy's estate can benefit from the full $11.18 million DSUE, even though the federal estate tax exemption has returned to $5 million (inflation-indexed).[5]

The Reality. Despite the intended simplicity, numerous issues arise in portability's practical application:

- The portability election requires the predeceased spouse's estate to file a federal estate tax return, even if one is not otherwise due. Most families will fail to file such a return due to lack of knowledge and/or the perceived administrative costs and hassles.
- The IRS can review and re-determine the calculation of the DSUE in the predeceased spouse's estate tax return upon the passing of the surviving spouse, even if the statute of limitations otherwise has expired.
- Portability does not offer the practical benefits of trust planning, nor does it apply to the federal generation-skipping transfer tax (GST) exemption or to state estate tax exemptions (unless applicable state law provides a separate portability election).

Accordingly, portability is not a complete failsafe to proactive planning and/or the use of trusts after the predeceasing spouse's passing. Numerous factors must be considered, including: (1) the value and type of assets owned and their potential for growth, (2) the projected value of the surviving spouse's estate and the estate tax exemption available at his or her passing, (3) the importance of creditor protection for the surviving spouse, (4) whether the couple wishes to create a dynasty trust for the benefit of descendants (since the GST exemption will not be ported), (5) the importance of receiving another basis step-up upon the surviving spouse's death, (6) the desire to control distribution of assets at a surviving spouse's death (important in blended families), (7) the likelihood of the surviving spouse remarrying, and (8) the application of a state estate tax with a non-portable exemption.

Requirement to Elect? Note that, even with the issues and possible costs associated with a portability election, a state Supreme Court held that a surviving spouse had standing to compel the deceased spouse's executor to file a federal estate tax return electing portability of the DSUE. The court held that each spouse's comprehensive waiver of marital rights under a prenuptial agreement did not apply to the portability election because the prenuptial agreement predated the enactment of portability.[6] Going forward, prenuptial agreements should specifically address the rights of the spouse with regard to the portability election, and married couples may want to consider ante-nuptial agreements specifically with regard to this issue, if there are concerns.

3. LIFE INSURANCE: TIME FOR A SECOND LOOK[7]

Existing life insurance should be reviewed periodically, but especially after major tax changes like the Tax Act, to ensure the policy's coverage and ownership still meet the family's needs and the policy is performing as projected. Matters to consider include:

Purpose. Why was the life insurance originally acquired (estate liquidity/tax liability, buy-sell funding, family security)?

Do those needs still exist (i.e., what is the family's current and projected tax exposure, asset allocation between liquid and illiquid assets, and/or dependence on income of the insured)? Can the policy facilitate basis management planning (e.g., continued use in trust funding, since no basis step-up is required for the policy proceeds)?

Type. Does the policy provide term or permanent coverage, and is the policy type appropriate for current needs? If term, is the policy convertible to permanent coverage, and on what terms? What is the total death benefit, is it still sufficient, and is any part guaranteed? Is there cash value growth, what is the current amount, is it currently accessible (and under what terms), what is the anticipated growth, does investment of the cash value need to be actively managed, and if so, by whom?

Re-Purpose. If the initial needs for coverage no longer exist (e.g., estate tax liability), can the policy be re-purposed as part of the insured's investment portfolio or as an alternative retirement savings vehicle? Can the existing coverage be replaced with a product better suited to the current economic environment (e.g., current assumption universal life (CAUL) or other interest rate-sensitive products for a rising rate environment)? If the policy is owned by an irrevocable trust, is the insured's spouse a current beneficiary, and/or can the policy be returned or sold to the insured if direct access is desired?

- Based on longstanding and appropriate tax principles, growth within the policy during the insured's life and payment of the policy death benefit upon the insured's passing generally are not subject to income tax. The policy owner may be able to access this cash value through policy loans or withdrawals (up to basis in the policy) without current income tax (if the policy is not a modified endowment contract (MEC)).

Restructure/Exchange. If funding premiums is an issue, what options are available to reduce premiums for that policy (e.g., apply policy dividends to reducing premiums of a whole life policy, changing from an increasing death benefit to level death benefit option for CAUL)? Alternatively, can and should the policy be exchanged for different coverage, with a different insurance carrier, for a different premium structure, etc.? If so, a tax-free exchange of policies under Internal Revenue Code §1035 may be an option, provided that the required procedure for such exchanges is carefully followed to avoid inadvertent tax consequences and/or lapses in coverage (see *WRMarketplace No. 14-39* for a discussion of these requirements).

Irrevocable Trust. For a trust-owned policy, is the trust, rather than the policy, the family's concern? Is the trust still needed (if not for estate tax concerns, then for practical management and creditor protection)? An irrevocable trust with terms that no longer suit the family's needs may be modified or decanted. Otherwise, the trust potentially can be unwound, such as by returning the policy to the insured (e.g., a policy sale if the ILIT is a grantor trust).

<u>Surrender</u>*.* If considering a policy surrender, the insured's current and future insurability should be reviewed, as re-acquiring life insurance in the future generally will be more expensive and may be impossible after significant health changes. The actual amount the family will receive from surrender should be determined first, net of any income taxes (which generally apply to any cash surrender value in excess of the premiums paid (less any prior non-taxable distributions from the policy)). Outstanding policy loans also must be taken into account, as the loan balance will be included in the cash surrender value for purposes of calculating the taxable income from the policy surrender.

- Any excess cash surrender value will be taxed at ***ordinary income, not capital gain, tax rates***. Further, if the policy is a MEC, an additional 10% penalty will apply unless the policy owner is age 59½ (or other limited exceptions apply).

TAKE-AWAY

The reality of tax reform necessitates a review of existing legacy and life insurance plans for families across net worth levels, whether to prune plans of unneeded provisions, to insert flexibility to ensure desired basis adjustments or available elections, and/or to take advantage of new, temporary transfer tax exemptions.

NOTES

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[1] From Paul S. Lee, Ellen Harrison, and Turney P. Berry, "*Putting It On & Taking It Off: Tax Basis Management Today (for Tomorrow)*," materials prepared for and presented at the 52nd Annual Philip E. Heckerling Institute on Estate Planning, Jan. 23, 2018; Steve R. Akers, *Heckerling Musings 2018 and Estate Planning: Current Developments,"* Section 5, February 2018, Bessemer Trust.
[2] Note the risk that the note provided to the trust will be deemed to have a zero basis, possibly resulting in taxable gain if the note is repaid after the termination of grantor trust status (e.g., after the grantor's passing). In other contexts, the IRS has generally argued that a debtor's basis in his or her note is zero, while the Tax Court has held that the debtor's basis equals the amount of the debt.
[3] Note that there are possible issues with each approach, for example, will the regulations under Internal Revenue Code §2036 apply to treat the grantor as holding the limited power of appointment even if it is not actually granted to him by the independent party, thus triggering estate inclusion even if not desired. See Akers at note 1 for additional discussion.
[4] From Jonathan G. Blattmachr and Martin Shenkman, "*The Best, the Most Intriguing, and the Scariest Ideas Culled from the 2018 Institute and Elsewhere and How to Make Them Work for You and Your Clients*," materials prepared for and presented at the 52nd Annual Philip E. Heckerling Institute on Estate Planning, Jan. 26, 2018.
[5] *See* Treas. Reg. §20.2010-2(c); Akers at note 1.
[6] *See In the Matter of the Estate of Anne S. Voss*, 2017 WL 167587 (2017).

[7] From Lawrence Brody, Mary Ann Mancini, and Charles L. Ratner, *"What the Heck(erling) Is Going on with Life Insurance Planning After Tax Reform? Planning When the Only Certainty is Ambiguity*," materials prepared for and presented at the 52nd Annual Philip E. Heckerling Institute on Estate Planning, Jan. 25, 2018.