Finseca Report
Marketplace

This Finseca Report Marketplace was prepared exclusively for Finseca Influencer members by Jonathan M. Forster, Partner, and Jacob L. Geiermann, Associate at **BakerHostetler**.

Highlights from the 2022 Heckerling Institute on Estate Planning

Market Trend: The more things change, the more they stay the same. Even though new tax legislation never occurred, the planning climate continues to evolve and clients must remain agile and vigilant. The volume and complexity of laws and planning considerations continues to increase, and it is imperative that professional advisors remain abreast of trends and recent developments.

Synopsis: Presenters at the 2022 Heckerling Institute on Estate Planning identified several enhanced areas of focus for legacy and life insurance planning, including: (1) recent developments in areas like intergenerational split-dollar; (2) private placement life insurance; (3) spousal estate planning; (4) business succession planning; and (5) trends in modern trust laws.

Take Away: There is no better time than the present to review existing legacy and life insurance plans for families. Given the range of matters to consider and address, clients will be best served by a holistic, team-based approach to their legacy and life insurance planning.

The following summarizes a few select insights from presenters at the 2022 Heckerling Institute on Estate Planning, reflecting our views on trends in legacy and life insurance planning.

RECENT DEVELOPMENTS: Top Five Things to Know[i]

Proposed Tax Legislation. In 2021, President Biden and Congressional Democrats were unsuccessful in seeking to enact sweeping changes to federal income tax and transfer tax laws, and many believe it is unlikely any major changes will be enacted this year. That said, tax law sunsetting remains on the horizon.

Retirement Plan Proposed Regulations. The IRS recently issued Proposed Regulations for retirement plans under the SECURE Act. The Proposed Regulations provide guidance and clarification on required minimum distributions that beneficiaries must take when a ten-year withdrawal period applies under the SECURE Act, which eliminated "stretch distributions" in most circumstances.

Corporate Transparency Act. Onerous disclosure requirements under the Corporate Transparency Act ("CTA") may become a major burden on family businesses and family investment companies. The CTA was enacted with money laundering and other corrupt practices in mind, but the law may require many family business and investment entities to disclose personal information for all controlling owners to the Financial Crimes Enforcement Network. Regulations were supposed to be released by January 1, 2022, but have not yet been released. The effective date for compliance by existing entities is one year after the final regulations become effective.

Incomplete Gift Non-Grantor Trusts ("INGs"). The IRS will no longer issue Private Letter Rulings regarding an ING's status as an incomplete gift trust for transfer tax purposes while also purporting to be a non-grantor trust for income tax purposes, and some states like New York and California have already regulated them out of existence.

Split-Dollar Life Insurance. A series of recent rulings provide a mixed bag of results on the use of split-dollar life insurance, focusing chiefly on inter-generational arrangements (i.e., *Morrisette*, *Levine*, and *Cahill*). Two key takeaways from these rulings are: (i) documenting the legitimate business purposes for acquiring the policy; and (ii) naming independent fiduciaries with clear obligations, especially when it comes to terminating the split-dollar agreement.

Observations

- *The possibility of tax increases may warrant planning now, before tax rates rise (from the Tax Cuts and Jobs Act sunset).*
- *Ten-year withdrawal periods from retirement accounts is now the new normal. The tax-deferral benefits of "stretch distributions" have been eliminated for most taxpayers.*
- *The CTA regulations will likely arrive soon…here's to hoping some reasonable exceptions are included.*
- *With the possibility of increasing tax rates, INGs will have increased popularity. However, given the IRS's decision to provide no further guidance and a number of states like NY and CA eliminating them, their risk may increase.*
- *Split-dollar life insurance has been a wonderful tool allowing for the funding of large trust owned life insurance policies. While the Levine ruling may appear to be a taxpayer victory, it is clear the IRS is not pleased. The industry may wish to tread lightly here to ensure that the most commonly used split-dollar rules aren't altered, as intergenerational split-dollar is far less widely used.*

DOMESTIC PRIVATE PLACEMENT LIFE INSURANCE: Increasing Tax Rates – No Problem[ii]

Private Placement Variable Universal Life ("PPVUL") has gained popularity in recent years, largely due to their tax-deferred nature and the wide range of investment opportunities available through such policies. PPVUL policies have a number of advantages when compared to commercial Variable Universal Life policies.

Domestic PPVUL. PPVUL policy cash values are held in separate or segregated accounts with the insurance company. This has the advantage of protecting policy assets from the general creditors of the insurance company. While offshore PPVUL was initially more common than domestic PPVUL, the tide appears to be turning. Recent tax law changes (such as adjustments to the statutory rates applied to the definition of life insurance under the Internal Revenue Code) and more willingness of major domestic carriers to issue PPVUL policies have helped to spark this trend. PPVUL policies are considered "securities" and are therefore subject to regulation by the Securities and Exchange Commission.

IDF vs. SMA. In addition to the common types of investment and management options available through a VUL policy, a PPVUL can have: (i) an Insurance-Dedicated Fund ("IDF") (to allow more types of investment opportunities); and (ii) a Separately Managed Account ("SMA") (to allow for different investment managers). IDFs and SMAs are both considered "sub-accounts" of the PPVUL policy, which must meet the diversification and investment control requirements noted below.

MEC vs. Non-MEC. PPVUL can be structured as a Modified Endowment Contract ("MEC") or as a non-MEC. A MEC is a life insurance policy which is funded more rapidly than a paid-up policy based on seven statutorily defined level annual premiums. Compared to a non-MEC policy, the primary disadvantage of MEC status is that distributions from the policy before the death of the insured are taxable.

Premiums. PPVUL can be funded through a split-dollar arrangement or a premium-financing arrangement. However, for premium-financing, third-party lenders may be less willing to permit use of the policy cash value as collateral, largely due to restrictions under "Regulation U" (a banking regulation which regulates margin accounts).

Investor Control. IRS rulings and published case law generally prohibit the policy owner from controlling how the policy is invested. While the policy owner can choose specific investment managers, they should not have any control over the investment decisions made by investment managers. This is an area fraught with risk, as many policy insured's (especially professional investors) want to take control.

Diversification. To comply with federal tax laws, the investments held in a PPVUL policy must be adequately diversified. Most of the diversification rules appear to be formulaic and objective, though IDFs and SMAs can significantly complicate the analysis.

Observations:

- *The tax tax-deferred nature of PPVUL investments is a key benefit, particularly if tax rates increase.*
- *The wide range of investment opportunities available through such policies is particularly attractive, and IDFs and SMAs provide significant flexibility.*
- *A number of states have lowered their premium tax rates to attract PPVUL business, such as South Dakota, Alaska, Utah, Wyoming, and New Hampshire.*

THE ELECTIVE SHARE AND COMMUNITY PROPERTY LAWS: This is Mine and That's Yours[iii]

The elective share and community property rules are mutually exclusive — generally they can dictate what the surviving spouse receives as their estate (as a floor imposed by state law).

Elective Share. The "elective share" is truly "elective"—meaning that a surviving spouse can (but is not required to) elect to receive it. Essentially, the elective share is the minimum amount which a surviving spouse is entitled to. If the surviving spouse is the wealthier spouse, then the elective share is generally inapplicable. If the surviving spouse is the less wealthy spouse, then the key questions are (i) what the elective share percentage is, and (ii) what assets are taken into account in the calculation. As to (i), some states provide for one-half, others provide for one-third, and others have varying percentages depending on the length of the marriage. As to (ii), some states only consider probate assets, others include a few types of non-probate assets, and others effectively include all assets owned by either spouse. Whether an interest in a trust can be considered as part of the elective share also varies by state. A surviving spouse's right to an elective share can at least partially defeat the predeceased spouse's estate plan. If an individual wants certainty that the elective share will not apply upon their death, a marital agreement might be able to provide such certainty.

Community Property. Community property is a term which generally means that assets owned by a married couple are deemed owned 50% by each spouse, whether actually titled in one or both spouse's names. The rules which apply to community property vary by jurisdiction, and special consideration should be given with respect to assets and income excluded from the statutory definition. Like the elective share, it is possible for married spouses to enter into a written agreement characterizing their assets or income as either community property or non-community property. If separate property is commingled with community property, it is possible (or perhaps likely) that such separate property has been "transmuted" into community property. A significant benefit of community property status is that, upon the death of the first spouse, all community property assets (not just the 50% interest of the predeceased spouse) receives a basis adjustment for income tax purposes. For example, if a married couple owns $1,000,000 in a stock with only $100,000 in cost basis, the new stock basis after the first spouse's death would equal $1,000,000, thereby allowing sale of the stock for $1,000,000 without payment of any capital gains taxes.

Planning Considerations. Given the great migration going on today, it is important to appreciate how this relocation can impact the status of your assets. Characterization of property as community vs. separate is critical in determining or ensuring who the trust grantor (creator) is, whether you can split gifts, creation of Spousal Limited Access Trusts, etc.

- **Non-Community Property State to Non-Community Property State**. This is relatively straightforward, as the spouses would simply be subject to a new elective share regime.
- **Community Property State to Community Property State.** This is also relatively straightforward, as the spouses would simply be subject to a new community property regime.
- **Non-Community Property State to Community Property State**. This is somewhat more complicated. The spouses can generally expect that their property will be owned as community property, but the various statutory exceptions should be carefully considered if non-community property characterization is desired. For example, many community property jurisdictions allow inheritances received by one spouse to remain that spouse's separate property if owned and maintained separately by that spouse.

- **Community Property State to Non-Community Property State**. This is much more complicated, as many non-community property states continue to respect the community property character of property, even after moving to the non-community property state. A rather complex set of rules applies with respect to “tracing” the source of assets owned and an even more convoluted concept of “quasi-community property” could apply as well. The current state’s “elective share” regime and the former state’s “community property” regime can concurrently apply with respect to different assets, further complicating the analysis.

Observations:

- *The exodus of high-income earners from high-tax states (such as New York and California) to low-tax states (such as Florida and Texas) continues.*
- *New York is a non-community property state, California and Texas are community property states, and Florida is a non-community property state but now allows couples domiciled there to create a “Community Property Trust” if desired.*

ESTATE PLANNING FOR THE FAMILY BUSINESS: Communication is Key [iv]

In closely owned family businesses, the senior generation owner has often developed numerous unwritten rules and policies and has the advantage of their seniority and respected position of authority within the family. While this status quo may be sufficient for the time being, things like death and divorce can quickly develop into major operational and succession problems for the business. A number of planning tools to help improve upon the status quo include:

Family Meetings. Family meetings can be used to address business and non-business issues, such as business operations, business succession, estate planning, charitable giving, etc.

Strategic Plans for Governance. While businesses in their early stages often operate without written strategic plans, it is important to formally outline future goals and strategies for the business, so as to provide a high-level overview of the family’s strategic vision.

Plans for Operation and Growth. Similarly, business owners should formally outline future plans for business operations and the growth and success of the business, to provide a roadmap for success in the near-term and mid-term.

Business Wealth vs. Personal Wealth. Business wealth and personal wealth, while separate and distinct in some respects, are inherently interdependent and should be considered together when planning for the business.

Succession Planning. This is an area where the senior generation needs to clearly express their intentions and set the next generation up for success by training and empowering them to lead the business. Far too many senior generation business owners are unwilling to give up control or are hypercritical of the junior generation’s business decisions.

Compensation Policies. Compensation of family members should be documented and considered in the same way compensation of non-family members is documented and considered. Written job descriptions and a comparison to published compensation data can help to create a more equitable and transparent compensation system.

Shareholder Education and Development. As more junior family members begin to acquire equity interests in a family business, it is important that they be properly educated on the numerous practical, technical, and personal aspects of company ownership.

General Values, Vision, and Mission. The general values, vision, and mission of the family business should naturally come to light through implementation of the foregoing, but a written summary of these important issues should be considered and discussed by the senior generation with the more junior family members involved in the business.

Observations:

- *Communication is key. The failure of family members to communicate is a recipe for disaster.*
- *Collaboration, not domination. While the senior generation continues to lead the business, it is important that more junior family members be actively involved and collaborate in the decision-making process.*
- *Human capital is often more important than financial capital.*
- *Outsiders are not the enemy. Professional advisors can provide a more objective perspective and help encourage family cohesion.*

TRENDS IN MODERN TRUST LAW: Irrevocable…Not So Much[v]

Four key developments of modernizing trusts include: (1) more flexibility in determining whether and when to share trust information with beneficiaries; (2) trust decanting; (3) nonjudicial settlement agreements; and (4) directed trusts.

More Flexibility in Determining Whether and When to Share Trust Information with Beneficiaries. Historically, full and transparent disclosure of trust information with beneficiaries has been the standard. The recent trend is to provide trust creators with more flexibility in determining whether and when trust information should be shared with beneficiaries. The extent to which a trust creator can waive or modify a trustee's duty to "inform and report" to the beneficiaries varies significantly by jurisdiction.

Trust Decanting. Much like decanting a bottle of wine, decanting a trust involves a transfer of trust assets from one container to another. Whether and to what extent the second trust varies from the first trust is a key consideration. Decanting can conservatively be used to modernize administrative provisions. A more aggressive type of decanting substantially changes the trust terms and might even be used to eliminate one or more trust beneficiaries. At least in some states, the concept of decanting has been blessed by the courts for decades as an extension of a trustee's ability to distribute trust principal. In recent years, many states have adopted decanting statutes permitting and regulating the decanting of trusts. In addition, many drafting attorneys include express decanting provisions in trust instruments, which may be more permissive than what would otherwise be allowed under the governing statutes. Despite the increased use of decanting, there is very little authority addressing trustee fiduciary duty concerns or the tax implications of decanting.

Nonjudicial Settlement Agreements. Unlike decanting, which is an action taken by the trustee of a trust, a nonjudicial settlement agreement ("NJSA") is an agreement between the beneficiaries of a trust (and in many jurisdictions, the trustee) with respect to the terms of a trust and/or the administration of a trust. The Uniform Trust Code includes a non-exclusive list of matters which can be addressed in an

NJSA, generally relating to administrative issues rather than the trust terms governing distributions. All beneficiaries (current and remainder) need to consent for an NJSA to be valid. This is where the "rubber meets the road" as most senior family members do not wish to share information with more junior family members. This distinction turned out to be critical in the *Estate of Levine* (split-dollar) case.

Directed Trusts. Another modern trend is the "slicing and dicing" of trustee duties through use of so-called "directed trusts," which allow individuals with special knowledge or skills to make key decisions on matters and to instruct the trustees to act accordingly. For example, a friend or family member can be given authority over trust distributions and a trusted advisor or key employee can be given authority over business decisions. Historically, this was roughly achieved through the appointment of two or more co-trustees and/or "special co-trustees." In recent years, many states have adopted statutes permitting directed trusts. While the titles used vary by state and by trust instrument, common titles for "directing parties" include: (i) "trust investment advisor" (authority over trust investments); (ii) "trust distribution advisor" (authority over trust distributions); and (iii) "trust protector" or "trust advisor" (authority over as many or as few matters specified in the trust instrument). While the statutes adopted in some jurisdictions allow directing parties to act on their own (much like a special co-trustee might be given such authority), the more common structure is simply giving the directing party authority to legally direct the trustee to act or not act in a certain manner. Some states may allow a directing party to serve in a non-fiduciary capacity, though most state statutes require them to act in a fiduciary capacity.

Observations:

- *Wealthy families need to appreciate that their long-term legacy plans may be altered significantly using a modification technique, and they need to decide if this is acceptable to them.*
- *Deciding when and what trust information to share with beneficiaries is something to be considered now, rather than later.*
- *Trust decanting is a powerful tool. If a trust creator has concerns about the possibility of decanting, consideration should be given to expressly restricting a trustee's ability to decant.*
- *NJSAs should be considered when addressing trust administration matters, rather than immediately resorting to court intervention.*
- *Directed trusts provide significant flexibility, and provide families with the closest thing to a private trust company experience without the cost and time.*

TAKE AWAY

There is no better time than the present to review existing legacy and life insurance plans for families. Given the range of matters to consider and address, clients will be best served by a holistic, team-based approach to their legacy and life insurance planning.

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[i] From Turney P. Berry, Jonathan G. Blattmachr, Carlyn S. McCaffrey, "*Recent Developments 2021/2022,"* materials prepared for and presented at the 56th Annual Philip E. Heckerling Institute on Estate Planning, March 28, 2022.

[ii] From Mary Ann Mancini, Lawrence Brody, Mike Cohn, "*Domestic Private Placement Life Insurance - It Ain't So Private Any More,"* materials prepared for and presented at the 56th Annual Philip E. Heckerling Institute on Estate Planning, March 30, 2022.

[iii] From Terry L. Turnipseed, "*One Hundred Percent of Marriages End: Elective Share (And Community Property) Planning for Modern Love and Migrating Couples,"* materials prepared for and presented at the 56th Annual Philip E. Heckerling Institute on Estate Planning, March 30, 2022.

[iv] From Joshua E. Husbands, "*Succession Planning for the Closely Held Business: Universally Unique,"* materials prepared for and presented at the 56th Annual Philip E. Heckerling Institute on Estate Planning, March 31, 2022.

[v] From M. Read Moore, "*Everything's Up to Date in Rapid City: New Norms in Trust Law,"* materials prepared for and presented at the 56th Annual Philip E. Heckerling Institute on Estate Planning, March 30, 2022.