WRMarketplace
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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: Administration's FY 2017 Budget - Part I: Same Old, Same Old?

MARKET TREND: With slim prospects of implementing any tax changes in the President's last year in office, the Administration's FY 2017 budget generally renews prior proposals that focus on the life insurance industry and the estate and income taxation of higher net worth individuals.

SYNOPSIS: Just in case you missed it, the Administration's FY 2017 Budget simply restates many proposals from last year's budget, including in the following areas:

FY2017 – Renewed Proposals		
Life Insurance	**Individual Tax**	**Transfer Tax**
• Expand interest deduction limitations for COLI policies • Modify the dividends received deduction for life insurers • Limit exceptions to the transfer for value rule for life settlements	• Increase top capital gains rate to 24.2% • Apply capital gains tax to appreciation in assets upon transfer by gift/bequest • Limit certain deductions for taxpayers in top tax brackets to 28%	• Reinstate 2009 transfer tax laws • Impose 10-year minimum terms and minimum remainders for grantor retained annuity trusts (GRATs) • Impose transfer taxes on grantor trusts

• Require specific information reporting for life settlements	• Impose a 30% "Fair Share Tax" on higher income taxpayers • Keep the charitable contribution base limit at 50% for cash contributions to public charities but 30% for all other contributions and extend the carry-forward period to 15 years	• Impose a 90-year limit on a trust's generation skipping transfer (GST) tax exemption • Create a new $50,000 annual gift tax exclusion category

The Administration also wants to expand the recently enacted basis consistency reporting rules to include (1) lifetime gifts and (2) bequests subject to the estate tax marital deduction.

TAKE AWAYS: As with past budgets, the FY 2017 Budget only represents the Administration's "wish list" for future tax legislation, and it is unlikely that Congress will even consider, much less pass, these proposals during a Presidential election year. Thus, opportunities remain for planners to use potentially-targeted planning approaches. As these proposals could have dramatic effects if enacted, however, AALU will continue to closely monitor legislative activity and interact with those who will craft any relevant tax reform legislation.

PRIOR WRM REPORTS: 15-05; 15-03; 14-11; 14-10; 13-16.

MAJOR REFERENCES: Budget of the U.S. Government Fiscal Year 2017; General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals (Feb. 2016).

The Obama Administration's federal budget for fiscal year 2017, as explained in the Treasury's General Explanations of the Administration's Revenue Proposals ("**2017 budget**" or "**budget**"), simply restates many prior proposals for changes to life insurance, individual, and transfer tax laws. The following provides a summary of some noteworthy proposals and what they could mean for advisors and clients if enacted (although it seems unlikely in this Presidential election year). Notable proposals affecting employee benefits and retirement planning will be reviewed in Part II.

RENEWED LIFE INSURANCE PROPOSALS

<u>Expanded Interest Deduction Limits for COLI Policies</u>. Currently, corporations cannot deduct interest on loans to buy or carry life insurance on any individual—subject to a *de minimus* key person exception.[1] 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.[2] The budget proposes to

limit the exclusion of COLI policies to only those insuring 20% owners and would apply to existing policies materially modified after the proposed effective date (December 31, 2016).

> ***What it Means***. This proposal effectively operates as a tax penalty to businesses owning life insurance by indirectly taxing the inside build-up of COLI policies and increasing the costs to businesses of acquiring cash value policies to insure their key employees, officers, and directors. Enactment could have a harmful impact on businesses, jobs, and employee benefits, given the importance of COLI in helping businesses remain in operation after the death of a key owner and employee and in financing and securing employee benefits.

Modified Proration Rules for Determining Insurer's DRD. Corporations may deduct dividends received from subsidiaries or other domestic corporations to avoid triple taxation (the "dividends received deduction" or "**DRD**"). For life insurers, the DRD is limited by the portion of the company's dividend income used to fund tax-deductible reserves for its obligations to policyholders. The budget would replace the methodology that carriers use to determine the DRD and require a separate determination of the DRD limits for an insurer's general account (supporting non-variable insurance products) and for each separate account (supporting variable policies and annuities).

> ***What it Means***. This proposal would disproportionately and adversely impact large life insurance companies, potentially increasing the cost and accessibility of life insurance products.

Limited Exceptions to Transfer for Value ("TFV") Rules. 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 or officer, respectively.[3] The 2017 budget would allow these specific exceptions to apply only if the insured was a 20% owner of the partnership or corporation.

> ***What it Means.*** The proposal seeks to limit the availability of TFV exceptions for life settlement transactions but the potential for an overly-broad application of this rule could result in taxation of common business planning transactions, such as business-related policy transfers (as in corporate mergers or acquisitions), roll-outs of split dollar arrangements to former employees or owners, buy-sell restructurings, etc.

Tax Information Reporting For Sales of Existing Life Insurance Contracts. The 2017 budget would impose new information reporting requirements for life settlements of policies with death benefits of $500,000 or more. Upon sale, the buyer would be required to report the purchase price, the buyer's and seller's identity, and the policy issuer and number to: (1)

the IRS, (2) the policy issuer, and (3) the seller.[4] Upon the payment of death benefits, the issuing insurer would be required to report the gross benefit paid, the buyer's identity, and the insurer's estimate of the buyer's basis to the IRS and to the payee.

> ***WHAT IT MEANS.*** This information would put an additional reporting burden on carriers to track settled policies and the buyer's basis in the policy after settlement. Also, consumers may want assistance from their insurance advisors with the preparation and filing of such reports, potentially shifting compliance concerns to the advisors.

Required Information Reporting for Private Separate Accounts. The 2017 budget would require 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.

> ***WHAT IT MEANS.*** Enactment of this proposal could allow the IRS to more closely evaluate private placement variable contracts and determine whether they should be disregarded as insurance contracts because the owners have retained too much investment control.

New Financial Institution Fee. The 2017 budget proposes a seven basis point fee on the "covered liabilities" of large U.S. financial firms with assets over $50 billion (although the fee would be deductible in computing corporate income tax). Covered liabilities are assets less equity for banks and non-banks based on audited financial statements, with a deduction for separate accounts primarily for insurance companies.

> ***WHAT IT MEANS.*** Financial institutions, including life insurers, impacted by this fee could pass on the additional expense to customers in the form of higher fees and higher costs for products and services, including life insurance products.

RENEWED INDIVIDUAL INCOME TAX PROPOSALS

Higher Top Capital Gains & Qualified Dividend Rate. Long-term capital gains ("**LTCG**") and qualified dividends are taxed at a top rate of 20% and subject to the 3.8% net investment income ("**NII**") tax (a combined rate of 23.8%). The budget would increase the capital gains rate to 24.2%, making the top effective federal rate 28% after inclusion of the NII tax.

> ***WHAT IT MEANS.*** This higher rate, especially if combined with state taxes, would significantly impact individuals who have substantial LTCG and dividend income and affect planning for sales and acquisitions of business interests. It also would make the comparative analysis of using lifetime gifts versus retaining assets to receive a basis step-

up even more critical for planning purposes. On a related note, the higher rates would further impact the economics of grantor trust planning, including the evaluation of the tax impact to the grantor and added benefit to the trust if and when an appreciated trust asset is sold.

Capital Gains Tax on Bequests/Gifts 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 long-standing tax principles. The budget would treat gifts and bequests of appreciated assets as sales that trigger 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).

What it Means. This proposal would dramatically impact overall tax planning for gifts and bequests and impose significant liquidity burdens for donees and estates, especially where highly-appreciated, illiquid assets are involved. This liability would be exacerbated by the proposed increase in the top federal LTCG tax rate and by applicable state income or capital gains taxes. Enactment of this provision would necessitate significant liquidity planning for high net worth individuals ("**HNWIs**"), likely increasing their need for life insurance.

30% "Fair Share Tax" ("FST") on High Earners. The budget proposes a 30% FST on the adjusted gross income ("**AGI**") of HNWIs, less a credit for charitable contributions. The FST would phase in starting at $1 million of AGI, with full phase in at $2 million (subject to inflation indexing). Individuals would pay the FST if it exceeds the sum of their: (1) regular income tax, (2) alternative minimum tax ("**AMT**"), and (3) FICA and Medicare tax due.

What it Means. The FST would operate as another alternative minimum tax on high income taxpayers and would apply in addition to the already higher income tax rates, proposed higher LTCG tax rate, and the 3.8% NII tax, resulting in a minimum federal tax burden of 30% of AGI less charitable contributions.

Reduced Value of Certain Deductions for Top Taxpayers. The budget would reduce the value to 28% of certain exclusions/deductions that are currently in the 33% and over tax brackets, including: (1) all itemized deductions, (2) tax-exempt state and local bond interest, (3) employer-sponsored health insurance paid for by employers or with before-tax employee dollars, (4) health insurance costs of self-employed individuals, and (5) employee contributions to defined contribution retirement plans and IRAs. Similar limits would apply for AMT purposes.

What it Means. The proposal effectively taxes otherwise deductible or excludable items at a rate equal to the difference between the applicable tax bracket and 28%, which could be significant for top-bracket taxpayers (e.g., taxpayers in the 39.6% bracket would see an 11.6% tax on the value of these items). Enactment of this proposal would minimize long-standing benefits associated with certain employee health and retirement benefits.

Consolidate Charitable Deduction Limits and Extend Carry-Forward Period. Currently, individuals may deduct up to the following percentages of their contribution base for certain types of charitable contributions:

- *Cash:* 50% for public charities, 30% for most private foundations
- *Appreciated capital gain property:* 30% for public charities, 20% for most private foundations
- *Capital gain property "for the use of"*[5] *a charity*: 20%

Charitable contributions exceeding these limits may be carried forward for deduction for 5 years, except that excess contributions for the use of an organization may not be carried forward.

The budget would keep the general contribution base limit at 50% for cash contributions to public charities but change the percentage base limit for all other contributions to 30%[6] and extend the carry-forward period for contributions in excess of these limitations from 5 to 15 years.

WHAT IT MEANS. This change would greatly simplify and incentivize charitable contribution planning, particularly by extending the carry-forward period. It also would ease administrative and compliance burdens for taxpayers and the IRS.

Taxation of Carried Interests as Ordinary Income. Managers of most hedge and private equity funds take a profits interest in the funds as a significant part of their compensation (referred to as a "**carried interest**"). If gains from a fund's underlying assets are LTCG, the managers will be taxed at LTCG tax rates on the gain allocated to their carried interest. The budget seeks to tax some portion of the carried interest at ordinary income rather than LTCG rates (i.e., 39.6% versus 20%) and to treat some of the gain from the sale or disposition of a carried interest as ordinary income.[7]

WHAT IT MEANS. Enactment of these or similar proposals would impact hedge funds and the private equity industry and magnify the tax and liquidity planning needs for fund managers. As HNWIs, these managers may already have significant tax exposure and frequently face liquidity issues, particularly in the early years of a fund.

RENEWED TRANSFER TAX PROPOSALS

The 2017 budget renews every transfer tax proposal from its FY2016 budget, including the Administration's desire to:

Return to 2009 Rates/Exemptions. Permanently reinstate 2009 transfer tax laws (45% top transfer tax rate; $3.5 million estate and GST tax exemptions, $1 million gift tax exemption), but with portability between spouses.

Impose Transfer Taxes on Grantor Trusts. Coordinate income and estate tax rules for grantor trusts, so that disregarded transactions between a grantor trust and its deemed owner for federal income tax purposes would incur an estate tax (at the deemed owner's death) or a gift tax (upon termination of grantor trust status or on a trust distribution during the deemed owner's life).

Impose Minimum Term/Remainder for GRATs. Require GRATs to have a 10-year minimum term and a minimum remainder value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed).

Limit Duration of GST Tax Exemption. Impose a 90-year limit on a trust's GST tax exemption.

Eliminate GST Tax Benefits for HEETS. Modify GST taxation of health, education and exclusion trusts ("**HEETs**") so that the tax exclusion only applies to direct payments by a donor (not a trust) to the provider of medical care or to the school in payment of tuition.

Create a New $50,000 Annual Exclusion Category. Create a new category of annual exclusion gifts with an annual exclusion limit of $50,000 per donor on transfers within this new category (which would include certain transfers in trust, transfers of interests in pass-through entities or that have sale restrictions, etc.). The exclusion would not require the donee (e.g., a trust beneficiary) to have a present interest in the gift.

What it Means. Many of these proposals would impact gift and trust planning, by limiting the exemption amount for lifetime gifts and making grantor trusts and GRATs, both of which use life insurance to plan effectively, far less attractive as planning tools. For example, a 10-year minimum term GRAT eliminates the use of short-term GRATs to hedge against the grantor's mortality risk or a GRAT's poor investment performance. A minimum remainder interest prevents "zeroing-out" the gift made upon the GRAT's creation for gift tax purposes.

The proposal for a new annual exclusion category without a present interest requirement, however, could substantially simplify insurance trust funding and eliminate the hassles of providing withdrawal notices (so-called "Crummey" notices) to trust beneficiaries.

EXPANDED REQUIREMENTS FOR BASIS CONSISTENCY REPORTING

As discussed in *WRMarketplace #15-37*, recently enacted legislation[8] requires recipients of inherited property to report an income tax basis consistent with the finally determined estate tax value of the inherited asset. The rule applies, however, only to inherited property that increases the decedent's estate tax liability when included in the decedent's estate. Thus, recipients of lifetime gifts or of assets that did not generate an estate tax (such as those qualifying for the estate tax marital deduction) do not appear to be covered by these rules.

The budget would expand the new basis consistency reporting requirements to apply to lifetime gifts and to estate assets that pass to a spouse but do not impact the estate's tax liability. A donor or decedent's estate, however, would need to file a gift or estate tax return to trigger application of these rules.

> ***WHAT IT MEANS.*** Enactment of this proposal would expand the already highly technical basis consistency rules and the information reporting requirements, generating new administrative burdens not only for estate fiduciaries and beneficiaries, but also donors and donees.

TAKE-AWAYS

- As with past budgets, the 2017 budget only represents the Administration's "wish list" for future tax legislation, and it is unlikely that Congress will even consider, much less pass, any of these proposals during a Presidential election year. Thus, opportunities remain for planners to use potentially-targeted planning approaches.
- As these proposals could have dramatic effects if enacted, however, AALU will continue to closely monitor legislative activity and interact with those who will craft any relevant tax reform legislation.

NOTES

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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[1] *See* Internal Revenue Code ("**Code**") §§ 264(a)(4) and 264(e).

[2] The pro rata interest disallowance is based on the ratio that the average unborrowed cash values held in COLI policies bears to the sum of (1) those average unborrowed cash values plus (2) the average tax basis of other assets held by the business. *See* Code § 264(f).

[3] 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.

[4] Currently, the seller of a life insurance policy in a life settlement must report taxable income on the difference between: (1) the amount received and (2) the owner's adjusted basis in the policy (i.e., total premiums and other consideration paid less (based on Rev. Rul. 2009-13), the portion of premiums allocated to the cost of life insurance protection). The buyer of the policy will incur tax on the difference between the death benefits received and the consideration and subsequent premiums it paid (unless an exception to the TFV rule applies).

[5] E.g., held in a legally enforceable trust or similar arrangement for the charity.

[6] Except for qualified conservation contributions, to which special rules apply.

[7] The 2017 budget also would require the manager to pay self-employment taxes on the earned income (although this may not be significant tax-wise, since passive income would otherwise be subject to the 3.8% NII tax).

[8] See the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (Pub. L. No. 114-41).