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TOPIC: Survey Says: Tax Reform & Client Planning - What Advisors Are Seeing & Saying.

MARKET TREND: Change creates opportunity. Facing uncertainty head-on with proactive, flexible planning can allay client concerns and give them a sense of control.

SYNOPSIS: While President Trump and the Republican-controlled Congress have promised major tax reform, uncertainty remains as to the final outcome. Despite this, the advisors surveyed indicate that many clients are still moving forward if the planning approaches satisfy their practical needs and provide flexibility.

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Irrevocable grantor trusts, grantor retained annuity trusts (GRATs), installments sales to grantor trusts, and charitable planning, particularly with donor advised funds, remain very popular options.

TAKE-AWAYS: Even in the face of major tax reform, clients and their advisors should remain optimistic and steadfast in their approach to implementing life insurance and legacy planning. Flexible, multi-faceted planning that can address both practical and tax issues is at a premium. Life insurance remains an ideal solution because of: (1) its unique attributes (instant, mortality-based liquidity and cash accumulation and death benefit payments on a tax sensitive basis) and (2) its ability to serve many critical objectives (tax, retirement, and liquidity planning, investment management and diversification, and family security).

With President Trump and the Republican-controlled Congress promising to pass major tax reform, uncertainty has been the name of the game for life insurance and estate planning advisors. To give a snapshot of the current planning environment, we posited the following questions to various attorneys, accountants, life insurance professionals, and financial advisors across the country to see how they are faring with their clients.

CURRENT MARKETPLACE: ARE CLIENTS STILL PLANNING?

While advisors provided mixed responses, most showed optimism.

<u>Don't Believe the Hype</u>. Advisors indicated that many of their clients are continuing to plan despite the uncertainty. These clients believe that, based on recent history (*i.e.*, sunset of Bush-era tax laws in 2010), certain tax changes like estate tax repeal either will not occur or will not be sustainable for the long-term, which makes current planning a continued priority.

<u>Wait & See</u>. As expected, another group of clients are opting to "wait and see." They have concerns about implementing the wrong planning approaches (and paying the associated costs) before seeing concrete legislation, particularly if they are satisfied with their current plans. Yet advisors indicate they have been able to incentivize some of these clients to move using the right motivators.

CONVINCE ME: WHAT ARE THE BEST MOTIVATORS?

The advisors surveyed generally found that the most effective planning incentives to motivate reluctant clients included:

Practical Needs. Tax considerations alone should not drive legacy and life insurance plans, since these plans also address other practical concerns of clients by providing:

- Centralized wealth management and the development of a coherent family investment philosophy
- Confidentiality and creditor protection for clients and family members (providing an elegant solution to pre- and post-marital planning for junior generations)
- Control of the flow of information and assets to younger beneficiaries
- A platform for teaching financial responsibility and stewardship with oversight using family and/or professional wealth managers/trustees
- A vehicle for business succession and family governance of shared assets (like real estate or private equity)
- Consolidation of assets in a single ownership structure to facilitate the transfer of diverse investments among generations without creating fractional ownership in underlying assets
- Pooling of assets within the trust/entity to provide greater access to certain investment opportunities and the ability to achieve better diversification and risk allocation

Lack of Permanence. Broad changes to current tax laws, including estate tax repeal, are far from certain. Further, any changes enacted may only survive for a relatively short-time, possibly due to a required 10-year “sunset” provision or a change in Presidential administrations. Regardless, the fundamental practical advantages of long-term legacy and life insurance planning will continue.

Flexibility. Flexibility can be incorporated into current planning to adapt to any future tax changes, such as (1) including multiple options in documents regarding distributions, powers of appointment held by beneficiaries, and the apportionment of tax liabilities based on existing tax laws, (2) giving clients powers of substitution over grantor trusts to reacquire low basis assets, (3) including “decanting” provisions, which allow trustees to distribute assets to a new trust with different administrative and distribution provisions, and (4) using trust protectors to make various discretionary tax elections or trust modifications.

WHAT ARE CLIENTS DOING?

Lifestyle vs. Legacy Capital Analysis. Clients want to understand their spending rates and the impact of inflation and possible tax changes on their net worth. A careful analysis of a client's ***lifestyle capital*** (the minimum assets needed to cover annual expenses, promote family goals, and maintain a family's lifestyle long-term, after inflation and taxes) versus the client's ***legacy capital*** (the assets remaining in excess of lifestyle capital, which a client can comfortably transfer) will be crucial to determining the type of planning a client can implement and with what assets. Monte Carlo or similar analyses will be helpful in determining these amounts.

Trusts. Regardless of tax changes, trusts will remain customizable, multi-purpose planning vehicles that provide control, ***creditor protection*** (a key concern for many clients), flexibility, family support, and wealth stewardship over several generations. The use of irrevocable trusts also ensures that trust assets remain outside of a taxable estate if estate tax repeal does not occur or remain permanent.

Limited Gift Planning. Planning that results in minimal or no taxable gifts and relies on current interest rates for its hurdle rates (e.g., the 7520 rate and the applicable federal rate) can reduce a client's taxable estate without eliminating the ability for basis step-up planning at death, according to longstanding and appropriate tax principles. Think zeroed-out GRATs and installment sales to grantor trusts. These "estate freeze" approaches:

- Take advantage of current low interest rates ***that are expected to rise soon.***
- ***Transfer only future appreciation, returning the initial value of the transferred assets to the client*** (plus growth up to the applicable hurdle rate).
- Allow clients to ***retain a predictable income stream*** from the transferred asset.
- ***Preserve gift and estate tax exemptions*** for later planning, if needed.

<u>Charitable Planning</u>. With many clients still focused on income tax issues, interest in charitable planning has increased. Contributions to donor advised funds have become popular, as they are far simpler and less costly to implement compared to other charitable planning approaches (like private foundations). They also provide higher charitable deduction limitations[1] and some degree of ***non-binding*** guidance over how the funds should be distributed. However, for charitably-inclined clients looking for more control and a long-term charitable legacy, private foundations may be preferred (see *WRMarketplace No. 2016-38* for a comparison of donor advised funds and private foundations).

While interest rates remain low, charitable lead annuity trusts ("**CLATs**") are another option. They are similar to GRATs,[2] except that a charity, not the grantor, receives the annuity payments. Funding a properly-structured grantor CLAT[3] can provide the grantor with a ***current income tax charitable deduction***, which can offset the costs of a life insurance purchase.

HOW EXACTLY DOES LIFE INSURANCE FIT IN?

Life insurance can efficiently serve multiple objectives as part of a client's overall legacy plan:

<u>Practical Planning</u>. Life insurance, especially in trust, can: (1) minimize family conflicts, (2) ensure flexibility, (3) provide liquidity for family support and post-death expenses, and (4) offer creditor protection and long-term wealth and tax management.

<u>Tax Concerns</u>. Life insurance policy death benefits and growth within the policy during the insured's life generally are not subject to income or capital gains tax. Further, the owner may be able to access cash value up to the owner's basis in the policy without current income tax.[4]

<u>Complementary Planning</u>. Effective estate freezes often depend on the market performance of the assets transferred and the client's survival. Life insurance acts as a non-correlated asset with regard to these issues, helping to offset the potential market and mortality exposure.

<u>Investment Management</u>. Many high cash value life insurance products can provide flexible methods to diversify an investment portfolio. Pertinent considerations include:

- Life insurance provides an immediate and substantial source of liquid assets at a predictable value, reducing family conflicts about estate liquidation and distributions.
- Depending on the product, a policy owner who acquires coverage for insurance purposes also may have the flexibility to consider increasing premiums or reducing policy death benefits to meet the policy owner's evolving insurance, asset, and investment needs.

Certain life insurance products, like current assumption universal life and whole life products, which typically benefit from a rising interest rate environment, may become particularly attractive. Reviewing analyses that show not only the internal rate of return ("**IRR**") relative to life expectancy ("**LE**") for a policy's death benefit, but also an IRR analysis 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 investment and tax planning goals.

<u>Flexibility & Customization</u>. ***Policies with cash value features not only serve estate planning, but also can supplement lifetime retirement planning***. Thus, even if the federal estate tax is repealed, more individuals may look to personal life insurance 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. Further, policies can be customized to provide for ***guaranteed benefits rather than cash value***, if the client wants to ensure a specific amount passes to his or her family.

Finally, ***return of premium riders can provide significant flexibility*** by returning premiums to clients if they decide to cancel the policy. Clients also can reduce policy face amounts, stop paying premiums, etc. Since clients can "pull the plug" on this planning, the overall commitment is nominal relative to other approaches. Clients can preserve their insurability now without feeling "locked-in," even if the approach is simply to buy a convertible term product.

TYING IT ALL TOGETHER

The importance of, and flexibility afforded by, legacy planning with life insurance is illustrated with an example of a trust that combines the features of an irrevocable life insurance trust (**ILIT**), a spousal lifetime access trust (**SLAT**), and a dynasty trust.

<u>Case-in-Point</u>. Assume the attorney for a married couple, Jack and Jane, recommends that Jack create a SLAT benefiting Jane, with the remainder passing in further lifetime trusts to their descendants. The SLAT would buy a life insurance policy on Jack with a $5 million death benefit and a significant cash value component.[5] Jack would use a portion of his federal gift tax exemption to fund the purchase and allocate a corresponding amount of his GST tax exemption. The trust will be a grantor trust for income tax purposes with regard to Jack. When Jack and Jane question the wisdom of moving forward with this planning in light of potential tax reform, the attorney suggests proceeding because:

- ***Life insurance is a mortality hedge and can ensure a family legacy*** on a cost-effective basis (i.e., amount of premiums relative to death benefits).
- Waiting can be detrimental. Purchasing now ensures Jack's insurability, and the IRR associated with the insurance purchase is generally better with a longer-term LE and an insured in good health.
- As a ***grantor trust***, the trust's income will be taxable to Jack, but the liability is mitigated by the tax treatment of the trust's life insurance policy.
- The SLAT ***can make distributions to Jane***, if needed, and can access policy cash value or loans to support these distributions.
- The $5 million death benefit provides ***estate liquidity without creating additional tax liability***.
- The dynasty trust provides ***long-term creditor protection and wealth stewardship*** for Jack's descendants.

- For flexibility and basis planning, Jack will have a ***substitution power over the trust assets***, and an independent person can have authority to ***grant general powers of appointments*** to Jack's descendants to ***achieve a basis step-up for trust assets***.

TAKE-AWAYS

Even in the face of major tax reform, clients and their advisors should remain optimistic and steadfast in their approach to implementing life insurance and legacy planning. Flexible, multi-faceted planning that can address both practical and tax issues is at a premium. Life insurance remains an ideal solution because of: (1) its unique attributes (instant, mortality-based liquidity and cash accumulation and death benefit payments on a tax sensitive basis) and (2) its ability to serve many critical objectives (tax, retirement, and liquidity planning, investment management and diversification, and family security).

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NOTES

[1] Charitable income tax deductions are subject to adjusted gross income ("**AGI**") limitations. The limitations for contributions to a donor advised fund are 50% of AGI (cash) and 30% of AGI (securities), while limitations for contributions to private foundation are 30% of AGI (cash) and 20% of AGI (securities).

[2] Unlike GRATs, CLATs can choose to use the §7520 rate in the month of creation or the rate from one of the prior two months. CLATs also can be structured as non-grantor trusts for income tax purposes, in which case the trust grantor would not receive an income tax deduction for his or her contribution to the CLAT (although the CLAT would receive an income tax deduction for its charitable distributions).

[3] The ability to take a full deduction for the amount contributed to a grantor CLAT in a given calendar year will be subject to the various percentage and other limitations and requirements imposed on charitable income tax deductions, although any unused deduction generally can be carried forward for up to five years.

[4] Assuming the policy is not a modified endowment contract (**MEC**).

[5] The policy is not a MEC.