Powered by Penton

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

APRIL 2017
$35.00

Spring Fling—"Femme à la robe rose" (24 1/4 in. by 16 1/4 in.) by Fritzner Alphonse, sold for $1,532 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017, p. 4.

BRIEFING

FEATURES

COMMITTEE REPORT

INSURANCE

PERSPECTIVES

www.trustsandestates.com

Your clients count on you. So do patients like Isabelle.

St. Jude patient Isabelle, Ewing sarcoma, and her mother.

ST. JUDE

Partners in Planning

SEMINAR

CHICAGO

May 10, 2017

Offering Continuing Legal Education and Certified Financial Planning education credits with sessions focused on Estate Planning

For registration information
(800) 804-7147 | stjude.org/partnersinplanning

St. Jude Children's Research Hospital®
ALSAC • Danny Thomas, Founder
Finding cures. Saving children.

TRUSTS & ESTATES

The WealthManagement.com Journal for Estate-Planning Professionals

Articles are generally peer reviewed by the advisory board and edited by T&E staff

TRUSTS & ESTATES

The WealthManagement.com Journal for Estate-Planning Professionals

Articles are generally peer reviewed by the advisory board and edited by T&E staff

Editor in Chief **SUSAN R. LIPP** susan.lipp@penton.com

Legal Editor **DAWN S. MARKOWITZ** dawnmarkowitz1@gmail.com

Associate Legal Editor **ANNA SULKIN** anna.sulkin@penton.com

Group Design Director **KATHY MCGILVERY** kathy.mcgilvery@penton.com

Group Art Director **SEAN BARROW** sean.barrow@penton.com

Contributing Editor, Philanthropy **CONRAD TEITELL** Cummings & Lockwood LLC

Contributing Editor, Retirement Benefits **NATALIE B. CHOATE** Nutter McClennen & Fish LLP

Group Digital Director **JASON WESALO** jason.wesalo@penton.com

Digital Product Development Manager **WILL HERTH** will.herth@penton.com

Group Production Manager **CAREY SWEETEN** carey.sweeten@penton.com

Production Coordinator **LAUREN LOYA** lauren.loya@penton.com

Advertising Operations Manager **MICHAEL PENELTON** michael.penelton@penton.com

For questions about your *Trusts & Estates* subscription please contact ***trustsestates@pubservice.com***

Reprints Contact penton@wrightsmedia.com 877-652-5295, or visit our website at *www.pentonreprints.com*

List Rental **DAVID SICKELS** david.sickels@penton.com 212-204-4379

Powered by Penton

Editorial and Business Office: 1166 Avenue of the Americas, 10th Floor, New York, NY 10036

ISSN 0041-3682, USPS 495-930

Trusts & Estates is published monthly by Penton Media, Inc., 9800 Metcalf Ave., Overland Park, KS 66212-2216. Periodicals Postage paid at Kansas City, MO, and at additional mailing offices. Canadian Post Publications Mail Agreement No. 40612608. Canadian return address: IMEX Global Solutions, P.O. Box 25542, London, ON N6C 6B2. **POSTMASTER:** Send address changes to *Trusts & Estates*, P.O. Box 15996, North Hollywood, CA 91615-5996.

CONTENTS & SUMMARIES

Note From The Editor

As most practitioners learn early on, the estate-planning field is multi-faceted and involves much more than just drafting wills for clients. Indeed, sophisticated estate planning often involves some degree of insurance planning. And, with the many different types of products out there, clients will look to you to help them figure out what works best given their particular situations and needs. In "Life Insurance Policy Selection and Design," p. 48, Charles L. Ratner and Lawrence Brody provide the tools to help you answer your clients' questions. They explore the types of policies appropriate for particular client needs, as well as how these policies should be designed and funded.

Making things even more complicated is the current environment of uncertainty that surrounds the tax laws. There's been talk of estate tax repeal, as well as the imposition of a capital gains tax on appreciated assets. As Melvin A. Warshaw explains in his article, "Life Insurance in Uncertain Times," p. 42, practitioners can use life insurance as a hedge against the current uncertainty, using vehicles like the hybrid domestic asset protection trust.

To keep you up to date on trends in life insurance, we asked Michael B. Liebeskind to update his 2016 article, "Key Trends in Life Insurance and Annuity Payments." His updated article is posted on our website at *www.wealthmanagement.com/research/key-trends-life-insurance-and-annuity-markets-download*.

This month, you may also notice some new names on our list of editorial advisory board members. Robert K. Kirkland, president of Kirkland Woods & Martinsen PC in Liberty, Mo., joins our Retirement Benefits Committee. Dean C. Berry, a partner at Cadwalader, Wickersham & Taft LLP in New York City, joins our International Practice Committee. We look forward to working with them on our board.

—Susan R. Lipp
Editor in Chief

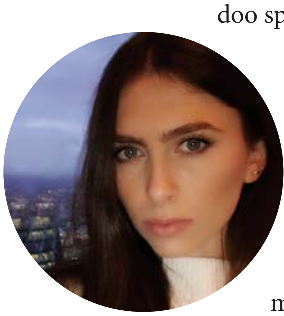
SHARE this article

CONTENTS & SUMMARIES

On the Cover

Our cover this month, Fritzner Alphonse's "Femme à la robe rose" (24 ¼ in. by 16 ¼ in.), sold for $1,532 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017. Born in Port-au-Prince, Haiti, Alphonse painted in a vibrant and colorful palette, which was reflective of the country's rich cultural history.

A self-taught artist like many of his Haitian peers, Alphonse had a bit of a late start—his childhood friend, the artist Calixte Henry, introduced him to painting when Alphonse was in his 30s. It's readily apparent that Alphonse's favorite subject was the female figure. Despite his religious background, his works frequently depicted women in a somewhat seductive nature. Also notable is that although he openly rejected the practice of voodoo (which was prevalent in Haiti at the time), he often painted his female subjects with blue skin—a symbol of the voodoo spirit/goddess Erzulie.



According to *The Harvard Crimson*, in 1998, a print of one of Alphonse's paintings, which was displayed in a Harvard dining hall, became the subject of controversy when a student complained that the depicted subject matter—black figures carrying watermelon and other fruits above their heads—was racist. The University promptly removed the painting. This seems unfortunate, as it's evident that the talented artist was simply depicting scenes from his own life (perhaps Google wasn't at the University's disposal back then).

—Anna Sulkin, Associate Legal Editor

Some of our other favorites, from Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017 include:

- p. 19, "Panthère" by Gabriel Alix, which sold for $11,494.

WealthManagement.com

Vice President, Financial Services Group **WILLIAM O'CONOR** william.oconor@penton.com

Publisher Emeritus **RICH SANTOS** richsantos@tengoalllc.com

WealthManagement.com Editor in Chief **DAVID ARMSTRONG** david.armstrong@penton.com

Business Manager **CHARLES USHER** charles.usher@penton.com

Group Marketing Director **JAY MCSHERRY** jaymcsherry@earthlink.net

Business Development Manager **JULIUS PICARDI** julius.picardi@penton.com

Sales Office
1166 Avenue of the Americas, 10th Floor, New York, NY 10036-5300; 212-204-4254; fax: 212-206-3622

Photocopies: Authorization to photocopy articles for internal corporate, personal or instructional use may be obtained from the Copyright Clearance Center (CCC) at 978-750-8400. Obtain further information at *www.copyright.com.*

Archives and Microform: For microform availability, contact National Archive Publishing Company at 800-521-0600 or 734-761-4700, or search the Serials in Microform listings at *www.napubco.com.*

Subscriptions and Back Issues: $375 per year within the United States, $400 for Canada, $400 for delivery to other destinations. Back issues are $35 each.

Please address subscription inquiries to: *Trusts & Estates*, PO Box 15996, North Hollywood, CA 91615-5996 or call 800-229-0543 (818-487-2043 from outside the United States). Fax: 818-487-4550. Email: trustsestates@pubservice.com. Additional resources, including subscription order forms and an editorial calendar, are available at *www.trustsandestates.com.*

Disclaimer

None of the content contained herein constitutes legal, accounting or other professional advice. Although it is intended to be accurate, neither the authors nor any other party assumes liability for loss or damage due to reliance on this material.

Penton is an Informa business

Circular 230 Notice

None of the articles published by Trusts & Estates *in any medium are intended to be used, nor can they be used, for the purpose of avoiding U.S. tax penalties.*

Images: Courtesy of Christie's Images Ltd. 2017

SHARE this article

CONTENTS & SUMMARIES

CONTENTS & SUMMARIES

New on trustsandestates.com

"New IRS Notice Targets Syndicated Conservation Easements" by Conrad Teitell, principal, Cummings & Lockwood LLC in Stamford, Conn.

"Increased Investing Through Family Offices" by Joe Freeman, senior managing director at Abbot Downing in Winston-Salem, N.C.

"Benefits and Risks of Premium Finance" by Aaron Hodari, managing director at Schechter Wealth in Birmingham, Mich.

Subscribers can log onto *trustsandestates.com* to view articles in the current issue.
You're ready to log onto the subscriber-only section of trustsandestates.com if—when ordering or updating your magazine subscription—you created your own user ID and password.

Haven't done that yet? No problem. Log in this way: your user ID is your *T&E* magazine account number. Your password is your five-digit zip code.

Find your account number on every issue of the magazine, every invoice and every renewal reminder. It starts with TE. Then, use the first six numbers that follow (drop the seventh number). Example: TE123456.

Forgot your username or password? Can't find your account number?
Contact Customer Service: Toll-Free: 800-229-0543, Phone (from outside the United States): 818-487-2043, Fax: 818-487-4550, E-mail: *trustsestates@pubservice.com.*

Tax Law Update

By David A. Handler, partner in the Chicago office of Kirkland & Ellis LLP, and Thomas Norelli, associate at the San Francisco office of Kirkland & Ellis LLP

•**The $250 billion price tag associated with gift tax repeal—**Estate and gift taxes have been an integral part of the U.S. tax regime for almost a century. However, over the course of the past two decades, there have been repeated overtures for their elimination. Now, with the advent of a new presidential administration, repeal of the estate and gift tax appears to be more likely than ever before.

In 2015, 238,000 gift tax returns were filed, generating $2.1 billion in revenue.[1] Elimination of the gift tax would undoubtedly directly result in the loss of such revenue to the government. Furthermore, elimination of the gift tax would also likely indirectly result in the loss of income tax revenue. According to the Joint Tax Committee in 2000, federal income tax revenue loss associated with repeal of the gift tax would be about $23 billion per year.[2] Over a 10-year period, the $23 billion income tax revenue loss, combined with the $2 billion gift tax revenue loss, would be equal to about a quarter trillion dollar loss in federal revenue. However, at that time, the top gift tax marginal rate was 55 percent (compared to 40 percent now), and the gift tax exemption was only $675,000 (compared to nearly $5.5 million now), so these figures would be lower today. Along with this projected loss to federal coffers, estimates using similar methodology calculate that the 43 states that have progressive income tax rate structures would suffer a $5.25 billion annual revenue loss to state coffers.[3]

The loss of income tax revenue would be the product of income tax saving strategies that would become viable in the wake of gift tax elimination. For example, without a gift tax, the use of a "straw taxpayer" would likely become a prevalent income tax planning strategy. One could freely transfer appreciated or income-producing assets from a taxpayer in a higher bracket to a taxpayer in a lower bracket without imposition of gift tax. This strategy would enable the higher bracket taxpayer to accumulate income or capital gains subject to the lower bracket taxpayer's lower marginal rates. Of course, the step-transaction doctrine could apply in some cases, but proper tax planning and timing would make it difficult for the Internal Revenue Service to detect such a strategy and succeed in imposing the step-transaction doctrine.

Further, a taxpayer could gift appreciated assets to a non-resident alien, who could then sell and re-gift the proceeds back to the taxpayer. The gains from such a transaction wouldn't be subject to any income tax, as non-resident aliens who sell appreciated assets that have no U.S. nexus don't recognize income taxable in the United States.

Absent a gift tax, taxpayers could gift assets to their elderly parents or other relatives to obtain basis step-up on death.

Elimination of the estate tax would also reduce income tax revenues, assuming basis step-up is retained. As taxpayers make lifetime transfers of wealth to avoid estate tax (whether using gift exemptions, sales, grantor retained annuity trusts and the like), the transferred assets don't obtain a step-up at the donor's death. The reduction of estate tax revenue from lifetime wealth transfers is partially offset by the loss of step-up, but without an estate tax, taxpayers would retain significantly more assets until death and receive a step-up. And, the taxpayers making wealth transfers are generally the ones with the largest unrealized gains.

It's clear that if Congress wishes to maintain the integrity of the progressive income tax, then the gift tax needs to be retained in some form. If Congress were to eliminate the transfer tax regime altogether, the economic consequences to the federal government could be immense.

• **IRS issues guidance on applicable exclusion amount and generation-skipping transfer (GST) tax exemption for same-sex spouses—**To apply the U.S. Supreme Court decision in *United States v. Windsor* and Revenue Ruling 2013-2017, the IRS has issued Notice 2017-15. This notice outlines administrative procedures for taxpayers and their estates to recalculate the remaining applicable exclusion amount and GST tax exemption to the extent that an allocation of that exclusion or exemption was made to certain transfers while the taxpayer was married to a person of the same sex.

If a taxpayer made a gift to his same-sex spouse prior to *Windsor* and the limitations period with respect to filing an amended return hasn't yet expired, then the taxpayer may file an amended gift tax return or

SHARE this article

supplemental estate tax return to claim the marital deduction (if it would have qualified) and restore the applicable exclusion amount and GST tax exemption allocated to that transfer. However, if the limitations period has expired, pursuant to Notice 2017-15, the taxpayer can recalculate his remaining applicable exclusion amount as a result of the recognition of the taxpayer's same-sex marriage as if a marital deduction applied. Importantly, Notice 2017-15 doesn't permit the change in value of the transferred interest or any other change in position concerning a legal issue after the limitations period has expired. Additionally, no credit or refund of tax paid on the marital gift can be given after the expiration of the period for credit or refund.

Following *Windsor*, generation assignments of a same-sex spouse and that spouse's descendants made for GST tax purposes are established based on the familial relationship between the same-sex spouses and not their age difference. Regardless of whether the Internal Revenue Code Section 6511 limitations period has expired, if a taxpayer had previously allocated GST tax exemption by filing a return or by operation of law before the date Notice 2017-15 was issued, and such transfer was based on a same-sex spouse's age-based generation assignment, the exemption allocated to such transfer is void. Therefore, the taxpayer is permitted to restore GST tax exemption allocated to transfers that were made for the benefit of transferees whose generation assignment subsequently changed pursuant to the *Windsor* decision, such that such transfer was now deemed to be made to a non-skip person.

To recalculate the remaining applicable exclusion amount or the taxpayer's remaining GST tax exemption accordingly, the taxpayer should use a Form 709, an amended Form 709 if the limitations period hasn't expired or Form 706 for the taxpayer's estate if the gift isn't reported on a Form 709. The taxpayer should include the statement "FILED PURSUANT TO NOTICE 2017-15" on the form filed. To recalculate an applicable exclusion amount pursuant to a marital deduction, the taxpayer should attach a statement supporting the claim for a marital deduction. If a taxpayer is making a qualified terminable interest property or qualified domestic trust election to obtain the marital deduction, the taxpayer must also file a separate request for relief in accordance with Treasury Regulations Section 301.9100-3. For recalculations of GST tax exemption, the taxpayer should attach a statement that the allocation of GST tax exemption in a prior year is void pursuant to Notice 2017-15 and a computation of the resulting exemption allocation(s) and the amount of the taxpayer's remaining exemption amount.

• **State supreme court forces portability election—**In *In re Matter of the Estate of Anne S. Vose v. Lee*, 2017 OK 3 (Okla. 2017), the Oklahoma Supreme Court affirmed the district court's holding that required the personal representative of a decedent to make a deceased spouse's unused exemption (DSUE) election. The surviving spouse had requested the personal representative to make the portability election, but the surviving spouse had also waived all of his rights to the decedent's estate in a prenuptial agreement.

The surviving spouse sought the order from the district court to require the personal representative (the deceased spouse's son from a previous marriage) to make the portability election. On appeal, the personal representative asserted that the district court erred on several grounds: lack of jurisdiction; issues with federal preemption; the surviving spouse's lack of standing; and that the order was contrary to a prenuptial agreement entered into between the surviving spouse and the decedent.

The court held that "the IRS itself acknowledged that the question of what state law actions might bring a surviving spouse within the definition of executor pursuant to 26 U.S.C.A Sec. 2203 are outside the scope of its regulations," thereby acknowledging the interplay between state laws concerning probate and estate distribution and federal estate tax provisions. Furthermore, 26 U.S.C.A. Section 2010 grants the personal representative a choice, and the statute as a whole is silent as to the effect state laws might have on how the administrator must make that choice. Therefore, the court held that preemption didn't apply, and as a result, the district court wasn't deprived of subject matter jurisdiction.

An Oklahoma statute provides that standing in a probate proceeding generally requires a pecuniary interest in the estate of the deceased. The court reasoned that because the portability election may give the surviving spouse a pecuniary interest, he had standing.

Furthermore, the court held that the prenuptial agreement didn't bar the surviving spouse's standing to seek an order to require the personal representative to make the portability election. The prenuptial agreement was entered into on May 24, 2006, but portability became an option in 2010. The court held that an indispensable part of effective waiver is a "freely exercised will to relinquish a known right," and that, despite the fact that the surviving spouse and the decedent clearly intended a comprehensive waiver of their marital rights under the law as it existed in 2006, they couldn't have possibly contemplated the surviving spouse's waiver of portability, because it didn't exist and was unforeseeable in 2006. Therefore, the court held, the prenuptial agreement didn't bar the surviving spouse from asserting an interest in portability of the DSUE.

The Oklahoma Supreme Court found no reversible error and affirmed the district court's holding that required the personal representative of a decedent to make a DSUE election.

Endnotes

1. 2015 IRS Data Book, Tables 2 and 5 (2016).
2. *Ibid.*, at Table 1.
3. *See* U.S. Census Bureau, "State Government Tax Collections 2015" (Sept. 23, 2016).

PHILANTHROPY

Breaking Up May Not Be That Hard To Do: Unwinding Marriages And Philanthropies: Part II

By Christopher P. Woehrle, associate professor of taxation at The American College of Financial Services in Bryn Mawr, Pa.

In my February 2017 column, I discussed the recent guidance from Private Letter Ruling 201648007 (Aug. 15, 2016) on the division of a charitable remainder trust (CRT) in the context of a divorce. Now, let's look at the difference between a "CRT-alimony trust" and a conventional alimony trust, as well as suggested criteria for choosing between the two. We'll examine the viability of a charitable gift annuity (CGA) as a non-trust alternative source for the payment of alimony and evaluate the termination of a charitable lead trust (CLT) as an option for the payment of alimony or property settlement.

A Comparison

Let's compare the CRT-alimony trust with an alimony trust.

CRT-alimony trust. PLR 201648007 showed the planning possibility with a previously established CRT. The division of a CRT qualifies as a tax-deferred transfer incident to divorce without triggering a gift tax or generating a federal estate tax. The unitrust or annuity trust amount can work like alimony but be subject to the more favorable tier accounting rules under Internal Revenue Code Section 664(b). Because the termination of unitrust or annuity trust payments on the remarriage of the former spouse is a qualified contingency, the arrangement operates like traditional alimony. It's also possible to establish a CRT for the purpose of using the unitrust or annuity trust amount as alimony. The payor-spouse receives the benefit of an upfront charitable deduction. Thus, the CRT can be used reactively or proactively as a planning technique for the payment of alimony.

Alimony trust. Of course, a newly established CRT-alimony trust requires charitable intent. For an obligor without charitable intent and an obligee insisting on assurance of payment, an alimony trust will be more appropriate. The obligor will transfer property in trust that specifies the amount to be paid to the obligee as the divorce decree mandates. Any principal remaining after the cessation of the obligation due to the death or remarriage of the obligee reverts to the obligor. Although the obligor is relieved of a support obligation, IRC Section 682 doesn't treat the obligor as the grantor. The income from the trust is excluded from the gross income of the obligor. For the obligor, the tax effect is as if the payment was an above-the-line deduction against gross income. The income is taxed to the obligee to the extent of distributable net income (DNI) under IRC Section 661. These rules afford the opportunity for some of the payments received to be tax-free. For example, if the alimony trust's payout is greater than its DNI, the excess is a tax-free distribution of principal.

But remember, the simplest form of alimony is a transfer of cash, free of trust.

Is the CGA an Alternative?

If the divorcing parties previously funded a CGA whose payments have commenced, the gift annuity agreement should have addressed the changing of the annuitants. If the agreement were a joint-and-survivor annuity with each entitled to half of the annuity payment, the charity can simply send two separate checks. If the agreement had successive rather than joint and survivor payments, the lead annuitant could waive the right to payment to start payment to the successor annuitant as part of a divorce agreement.

If the divorcing parties are considering establishing a CGA, its comparative simplicity to the CRT and the tax-free return of principal of the payments during the life expectancy of the annuitant would be very attractive. However two major hurdles need to be cleared:

(1) IRC Section 514(c)(5)(B) requires the annuity only be paid over the life of one individual or the lives of two individuals living at its issuance. A CGA may not be for a term of years or cease under a "qualified contingency" such as remarriage as is permissible for a CRT. The party funding a CGA for the benefit of a former spouse may not want to provide a lifetime income.

(2) The initial funding amount for a CGA will be larger than the amount needed for funding a charitable remainder annuity trust (CRAT) or charitable remainder unitrust paying the minimum payout rate of five percent. For annuitants age 68 or younger, the payout rate is less than 5 percent. For example, if the divorcing parties agreed to annual alimony of $50,000 for an annuitant age 59, the CGA would need to be funded with approximately $1.16 million. This amount is 16 percent greater than the CRAT funded with $1 million, assuming the obligor wishes to maximize the charitable deduction from the CRT-alimony trust by using the minimum payout rate of 5 percent. It's more than twice as much needed to fund a CRAT, which would barely satisfy the 10 percent charitable remainder requirement. Of course, Section 514(c)(5) permits an obligation to pay a CGA to avoid acquisition indebtedness with a present value as little as 10 percent. Because most charities adhere to the American Council on Gift Annuities rates, it's unlikely an obligor would be able to negotiate a CGA with such a small present value for the remainder interest.

CLT for Dissolution Planning

The grantor may wish for the principal to revert to him to provide an asset to be transferred to his former spouse. These assets could be used for a property settlement or funding alimony payments and are governed by the regular income and transfer rules that apply to a divorce.

At first blush, Revenue Ruling 88-27 appears to foreclose any possibility of commutation. It concluded that an inter vivos charitable lead annuity trust (CLAT) doesn't qualify as a guaranteed annuity interest under IRC Section 2522(c)(2)(B) and Section 2522(a) if the trustee had the discretion to commute and prepay the charitable interest. Thus, the entire charitable gift tax deduction was lost, exposing the entire transfer to gift tax.

It further noted that the result would have been the same even though the trust permitted a prepayment calculation using the methodology and discount rate used to calculate the present value of annuity payments under the IRC. Because the exact amount that would be payable to charity couldn't be determined as of the date of the gift, there was no qualified CLAT interest.[1]

But, what if the trustee would pay a commuted payment amount equaling the nominal value of the remainder payments to charity?

A series of PLRs show that the reversion to the grantor may be accelerated, so long as the charities receive the undiscounted nominal balance of payments due, and the trust didn't permit commutation. In PLR 199952093 (Oct. 7, 1999), the IRS approved a commutation in an amount equaling the remaining undiscounted annuity obligation to charity.[2] The remaining assets were distributed to the non-grantor remainder beneficiary before the original termination date of the trust. The IRS also ruled the private foundation status of the trust wasn't terminated nor were there any self-dealing issues under IRC Section 507. In PLR 200226045 (June 28, 2002), the IRS even approved the return of assets to the remainder beneficiary, a non-exempt limited partnership, even though there wasn't a commutation.[3]

While the taxpayers' motivations in the PLRs weren't in a divorce context, their rationale should govern.

So, commutation should be an option to accelerate the reversion of an asset to a grantor or a nongrantor as part of a plan for using the asset in a divorce settlement.

Worth the Effort

Charitable planning coordinated with dissolution planning merits serious examination. The work involved is well worth the effort to assure divorcing parties have maximized the use of all marital assets in a tax-efficient manner.

The four techniques are summarized in "Techniques Available for Funding an Alimony Obligation," this page.

Endnotes

1. Private Letter Ruling 9734057 (Aug. 22, 1997) addressed the issue of commutation of a testamentary lead unitrust. It ruled the termination of the charitable lead unitrust disqualified the trust property for the estate tax charitable deduction.
2. The assets of the charitable lead trust (CLT) were shares in a privately held bank that subsequently went public. The assets had grown from $4 billion to $22 billion. The remaining payments owed to charity were $2.8 billion.

Techniques Available for Funding an Alimony Obligation

A comparison

TECHNIQUE **Cash Free of Trust**	**Alimony Trust**	**Charitable Remainder Trust (CRT)-Alimony Trust**	**Charitable Gift Annuity**
DEDUCTION FOR PAYOR Yes, against adjusted gross income (AGI)	No, though payor not taxed on payments from trust	Charitable deduction for payor	Charitable deduction for payor
INCLUSION INTO GROSS INCOME OF PAYEE Yes, in full, as ordinary income	Yes, to the extent distribution is less than or equal to distributable net income. Potential for tax-free returns	Yes, but potential for some of the distribution to be taxed more favorably under tier accounting rules	Yes, but portion of payment will be tax-free return of principal
SPECIAL COMMENTS To the extent the payor's AGI is reduced, the donor's AGI floor medical expense deduction is lowered, increasing the likelihood of the deductibility of medical expenses However, the reduction in AGI increases the chance of the nondeductibility of charitable contributions and the taxability of Social Security payments	Payor's AGI won't be reduced by distribution	Charitable intent of payor-settlor must be sufficient to gift enough principal to fund alimony obligation Qualified contingency under Internal Revenue Code Section 664(f) must be carefully drafted in the current low IRC Section 7520 interest rate environ Payor receives charitable deduction for present value of charitable remainder interest, which may be nominally greater than a conventional alimony payment stream Payee is taxed under the tier accounting rules, which may be more favorable than either a conventional alimony payment or a payment from an alimony trust	Charitable intent of payor must be sufficient to gift enough for principal to fund alimony obligation Qualified contingency is unavailable; payor-settlor must be content to fund a lifetime income to former spouse even through a remarriage Payee is taxable under the recovery of basis rules governing annuities. The result may be more favorable than a conventional alimony payment Payee is taxed under the tier accounting rules, which may be more favorable than either a conventional alimony payment or a payment from an alimony trust

—Christopher P. Woehrle

3. The Internal Revenue Service approved the retention of assets in the CLT with excess assets being distributed to the remainder beneficiary. Specifically, the assets retained equaled 110 percent of the remaining and undiscounted payments owed. The value of the CLT less the provision for the retained assets benefiting charity was the value to be distributed to the remainderman.

TIPS FROM THE PROS

Speak Now or Forever Hold Your Peace of Mind on Taxable Gifts

By Louis S. Harrison, partner at Harrison & Held LLP in Chicago

Estate-planning professionals will remember the beginning of 2017 as a bit tart, as in "TART," "Trump's Attempt to Reform Taxation." As planners await what will come out of changes in the tax laws, such as, will there be estate tax repeal, no estate tax repeal, loss of step-up in basis, increased exemption amounts and impacts on charitable gifting, the effects of such uncertainty on all aspects of estate planning can be stultifying.

Let's examine this uncertainty in the context of lifetime taxable gifts.

Lifetime Taxable Gifts

The first $5.49 million of lifetime taxable gifts incur no actual gift tax payment, as it's covered by the lifetime gift exemption. Thereafter, each $1 made in taxable gifts is subject to a 40 percent tax and gift tax payment.

In an economically rational world, under a unified estate and gift tax system, the making of lifetime taxable gifts could lower the overall estate and gift tax bite and, as such, is a rational planning strategy.

That topic has been expectorated and re-expectorated in scholarly articles quite a few times in the last three decades. The conclusion about the benefits of lifetime taxable gifts isn't inherently intuitive.

I recall spouting off to a law school class (it was a night class so half the students were already in a persistent vegetative state from their day jobs by the time they arrived at school) that the gift tax system was tax exclusive, while the estate tax system was tax inclusive, or was it the other way around? I then spent the next 60 minutes explaining why paying gift tax could be tax beneficial. I'm fairly certain no student got it; or wanted to get it; or felt good about it.

But, the conclusion and planning is rational.

Example: Dad is the surviving spouse and lives in Florida, where there's no state estate tax. He has an estate of $10.49 million. His lawyer, who's a good friend, has assured dad that not only will the lawyer not charge for administration, but also, the lawyer will pick up all debts and other expenses of administration as a "thank you" for all the nice things Dad said about the lawyer during Dad's life. Hence, Dad's expected taxable estate is exactly $5 million over the exemption amount, for a tax of 40 percent multiplied by $5 million, or $2 million. This will leave $5.49 million + $3 million ($8.49 million) remaining for his children.

But, Dad is 80 and in poor health. If more than three years before he dies, Dad gifts $8.49 million to his children, this will result in $3 million subject to tax at a 40 percent tax rate, resulting in $1.2 million in tax due. After paying tax and making the gift, he has $800,000 left. If he pays 40 percent on this $800,000 in estate tax, this leaves him with $480,000 ($800,000 – 40 percent tax on $800,000). He then would have given his kids $8.49 million + $480,000, for a total of $8.97 million with this lifetime taxable gift, versus the $8.49 million that he would have left if there were no taxable gifts.

Rationality Isn't Always Omnipresent

As estate planners, we understand that paying gift tax (and ignoring the time value of money concern with the gift tax paid) is a legitimate planning strategy for those who will pay estate tax. And, we discuss this strategy with clients, getting buy-in on, at most, one out of four occasions.

The question is, when clients want to get more funds to their children and feel that they have enough to live on, why don't 100 percent of them make lifetime taxable gifts with gift tax payments.

Forrest Gump says, "Irrationality is as irrationality does."

The answer: We aren't automatons, acting rationally in all environments. And, we're certainly not rational when it comes to all economic decisions. Author Michael Lewis has elevated the area of behavioral finance to our consciousness. Books like *The Undoing Project: A Friendship That Changed Our Minds* have highlighted the somewhat asymmetrical way human beings look at decisions, not as rational actors making objective decisions that maximize our economic well being, but as emotional beings that are influenced by "how we feel" about stuff as much as how it will impact us.

One such principle demonstrated by behavioral finance is myopic loss aversion, in which the pain of losing is much greater than the happiness of winning.

For example, our happiness when our portfolio increases by 5 percent is, say, at X. (Isn't X always the random variable that stands for all sorts of things? If I were the letter X in the alphabet, given my importance in standing for all sorts of things, I would ask to be moved up, like after B or C, and not stay at the lowly end of the alphabet). But, our unhappiness if the portfolio goes down by 5 percent is (I'm making this up, but it's somewhere in this neighborhood) 4X. Therefore, a decision that has a 50 percent probability of increasing our portfolio by 5 percent, if it also has a 50 percent probability of decreasing it by 5 percent, may not be made, even though the expected value isn't negative (it's zero, so we should be disinterested in making that investment choice).

Returning to the world of gift tax payments (and no, I didn't torture my students with this behavioral finance concept), we can potentially save $480,000 in our example in estate taxes (after taking into account the payment of gift taxes). But, it costs us the pain of making a tax payment now.

There are different ways to look at this, but one way is as follows: The payment of gift taxes now is a LOSS. It feels very painful to our clients.

The saving of estate taxes in the future is a GAIN (but because it's in the future, another behavioral finance principle discounts that value at irrationally high discount rates). Even though the GAIN substantially outweighs the LOSS in dollars, the LOSS is more emotionally painful than the happiness of the GAIN. Hence, our clients may not make the gift. (We noted at the beginning that the clients actually wanted to get funds to their children and that they didn't feel that they needed the money that they would gift.)

Paying Gift Tax Has Been Trumped

We now live in a world where the estate tax system may disappear. If that indeed happens, even if the gift tax system remains, clients won't want to pay gift taxes. The myopic loss aversion to paying gift taxes would boil up in our clients, much like our anger when we can't clearly read our texts while driving.

Even though in our current environment, paying gift taxes could save estate taxes, and is therefore a rational strategy, our clients won't view it this way if, this year or next, the estate tax is repealed. And this is so, even if the estate tax is repealed "temporarily." Remember, we're dealing with emotional actors here, those actors being our clients.

Accordingly, strategies that result in the payment of gift taxes have to be put on hold in 2017.

Alternative Structures

While we wait for the tax change dust to settle, gift tax payment strategies now need to be structured alternatively.

Example: Assume Dad wants to do a sale to a grantor trust, but needs to have $3 million of seed money in the trust for the down payment. Typically, planners would advise Dad to make a gift to transfer these funds to the trust, even if the gift exceeded the lifetime gifting credit and a gift tax would be payable. In 2017, an alternative structure needs to be worked out. This could be third-party financing guarantees by the trust beneficiaries, loans by trust beneficiaries or even a short-term (2-year) grantor retained annuity trust (but keep in mind that the grantor trust then couldn't be a generation-skipping transfer). If a loan or financing arrangement is used, and the estate tax system isn't repealed, perhaps the loan or financing structure could be turned into a gift later this year or next.

Happy 2017 Trails

I've dedicated this column to payment of gift taxes, essentially saying, "don't do it in 2017." The year 2017 is one of change. It could be a year of indecision and a year of focus for us as estate planners. We have to avoid the status quo bias of doing nothing and, instead, approach our planning with two end games in mind: the estate tax system remains, or the estate tax system is repealed. With each traditional planning strategy that we use, there are iterations that work fine under either of these two results, and we shouldn't be timid about considering these iterations.

By **Jessica Galligan Goldsmith** & **David Y. Choi**

Saving the Store

Lifetime planning for business owners using IRC Section 6166

Internal Revenue Code Section 6166 is one of the most favorable sections for taxpayers who own closely held businesses. Attorneys who represent business owners must understand the technical rules that apply with respect to IRC Section 6166. Many decedents who could qualify for deferral of federal estate tax under Section 6166 (6166 deferral) will miss this opportunity solely due to a lack of lifetime planning. Without Section 6166 planning, a family business may need to be sold to pay estate taxes.

The estate of a U.S. citizen or resident decedent[1] with assets in excess of the federal estate tax exclusion amount is required to pay approximately 40 percent of such excess in federal estate tax.[2] A decedent's worldwide assets are subject to federal estate tax,[3] and the deadline to pay such estate tax is generally nine months following date of death (the payment date).[4] The specter of substantial federal estate tax is a significant concern for business owners. Fortunately, 6166 deferral can provide relief from an immediate federal estate tax burden, thereby helping to preserve a family business.

Section 6166 provides a statutory right for an executor of a qualifying estate to make one of four different elections (each a 6166 election) on a timely filed federal estate tax return, including valid extensions thereto. A 6166 election extends the time for paying the federal estate tax on a decedent's closely held business interests.[5] As long as an estate makes a timely election under Section 6166, the Internal Revenue Service can't deny the extension of time to pay such federal estate tax that would otherwise be due by the payment date.

Closely Held Business Interest

To qualify for 6166 deferral, a decedent must own an interest in a "closely held business" established as a sole proprietorship, a partnership or a corporation.[6] Limited liability companies (LLCs) aren't expressly mentioned in the statute. However, the IRS appears to have accepted LLCs as partnerships for Section 6166 purposes.[7] A decedent's interest in a corporation or partnership will be treated as an interest in a closely held business if the business entity has 45 or fewer partners (or shareholders) (the 45-member requirement), or the gross estate of the decedent owns: (1) 20 percent or more of the total capital interest of a partnership, or (2) 20 percent or more of the voting stock of a corporation (the 20 percent capital requirement).[8]

> **Example 1:** A decedent dies owning a 20 percent interest in ABC Partnership. No other members of the decedent's family own interests in ABC Partnership. At the date of the decedent's death, ABC Partnership has 46 partners, including the decedent. The partnership doesn't meet the 45-member requirement. However, the decedent's interest meets the 20 percent capital requirement. The decedent's interest in the partnership is an interest in a closely held business for Section 6166 purposes.

To determine whether a business meets the 45-member requirement, a decedent is deemed to own all of the business interests owned by certain of the decedent's family members.[9] In addition, any joint interests held by spouses are treated as owned by a single partner or shareholder.[10] These family

Jessica Galligan Goldsmith and **David Y. Choi** are partners at Kurzman Eisenberg Corbin & Lever, LLP in White Plains, N.Y.

attribution rules make it easier for a business to meet the 45-member requirement.

> **Example 2:** A decedent dies owning an interest in ABC Partnership. At the date of the decedent's death, ABC Partnership has 48 partners, including the decedent. Three of the partners are family members of the decedent, including the decedent's sister, father and child. ABC Partnership meets the 45-member requirement. ABC Partnership is deemed to be a closely held business, regardless of whether the decedent's interest in ABC Partnership meets the 20 percent capital requirement.

Any business interest owned by a trust or estate will be deemed to be owned by its current beneficiaries.[11] Therefore, if business interests are owned by sprinkling trusts, the number of business owners can expand dramatically. Siblings are included as family members, but others, such as nieces, nephews and cousins, aren't. Estate planners should exercise caution when using sprinkling trusts with respect to succession planning, as trust ownership may cause a family business to fail the 45-member requirement.

The 35 Percent Test

To qualify for 6166 deferral, the value of a decedent's closely held business interest must be greater than 35 percent of the decedent's adjusted gross estate (the 35 percent test).[12]

Valuation adjustments. For Section 6166 purposes, the value of a business interest is its fair market value (FMV) after adjustments for minority interests,[13] reduced by any passive assets held in the business.[14] By contrast, the decedent's adjusted gross estate includes both the active and passive assets in the business.[15] The existence of passive assets in a closely held business can make it difficult to satisfy the 35 percent test.

Many family businesses begin with a senior generation, and the ownership of such businesses is often diluted in succeeding generations. After adjustments for lack of control and/or lack of marketability, the value of a decedent's business interest may not meet the 35 percent test. Because passing that test is critical to a Section 6166 election, gift planning for non-business assets should be considered during a business owner's lifetime. Although lifetime gifts are added back for federal estate tax purposes, transferring non-business assets during a decedent's lifetime will give the estate a better chance of passing the 35 percent test.

Passive assets. As noted above, passive assets aren't included in determining whether the value of a decedent's closely held business interest meets the 35 percent test.[16] The term "passive asset" is defined as any asset other than an asset used in carrying on a trade or business.

> **Example 3:** A decedent dies owning an interest in ABC Partnership, a closely held business. ABC Partnership owns a retail store and a hedge fund interest. For estate tax purposes, the decedent's adjusted gross estate will include the value of the active business assets of ABC Partnership as well as the hedge fund interest. However, to qualify for Section 6166 deferral, the value of the decedent's interest in ABC Partnership, excluding the interest in the hedge fund, must be greater than 35 percent of the decedent's adjusted gross estate.

Clients should be aware of the 35 percent test when financing or refinancing a closely held business.

Clients should be aware of the 35 percent test when financing or refinancing a closely held business. Cash in a business that isn't needed for operating expenses is a passive asset that will be included for estate tax purposes but disregarded for Section 6166 purposes. Similarly, refinance proceeds that are distributed to the business owner but not reinvested will be included in the estate. Estate planners also need to be mindful when selling business assets to trusts for future generations. If business assets are sold for promissory notes, then any unpaid notes held in an estate will be non-business assets. In each instance, poor planning can negatively impact the 35 percent test.

Revenue Ruling 2006-34 clarifies when a family business is sufficiently active to qualify for Section 6166 deferral. Rev. Rul. 2006-34 sets forth factors

that determine whether a decedent's real estate management activities constitute an active trade or business.[17] Important factors include the time the decedent, the decedent's agents and/or the decedent's employees devote to the business, whether an office is maintained with regular business hours and whether the decedent, agents and/or employees are actively involved in maintaining and expanding the business. Rev. Rul. 2006-34 is an important guideline in determining whether a closely held business is active rather than passive for Section 6166 purposes.

The 6166(a)(1) election entitles an estate to pay estate taxes in 10 equal annual installments and to defer the initial tax payment for five years from the payment date.

The Four Elections

Each of the four 6166 elections extends the time for paying the federal estate tax on closely held business interests.[18] The most beneficial Section 6166 election is the election under Subsection 6166(a)(1) (the 6166(a)(1) election). The 6166(a)(1) election yields the longest 6166 deferral. The other three elections under Sections 6166(b)(7), 6166(b)(8) and 6166(b)(10) yield shorter deferral periods and will be discussed below.

The 6166(a)(1) Election

Fourteen-year deferral. The 6166(a)(1) election entitles an estate to pay estate taxes on the closely held business interests in 10 equal annual installments and to defer the initial tax payment for five years from the payment date.[19] The 6166(a)(1) election is the only 6166 election that provides an interest-only deferral period. If an estate makes a successful 6166(a)(1) election, then the final installment payment of federal estate tax can be deferred up to 14 years from the payment date.[20]

Aggregation. To qualify for a 6166(a)(1) election, a decedent's interest in a closely held business must pass the 35 percent test. An estate can make separate 6166(a)(1) elections for two different business interests. Alternatively, an estate can aggregate a decedent's closely held business interests when the FMV of each business interest, after applicable valuation adjustments, is at least 20 percent of the value of the specific business as a whole (the 20 percent threshold).[21]

Section 6166(c) aggregation is available for all four 6166 elections, but an estate must meet the 20 percent threshold without family attribution to make a 6166(a)(1) election. Notably, the spouse's interest in the business is included automatically when computing the decedent's 20 percent threshold.[22] It's irrelevant whether the decedent's businesses are related for aggregation purposes.

> **Example 4:** A decedent dies owning a 30 percent interest in both ABC Partnership and DEF Partnership. The decedent's interest in each partnership doesn't by itself pass the 35 percent test. After cumulative 25 percent adjustments, the decedent's interest in each partnership is valued at 22.5 percent of the partnership. Therefore, the estate's interest in each partnership meets the 20 percent threshold. The estate can aggregate the interests in the two partnerships into one closely held business interest to meet the 35 percent test for purposes of the 6166(a)(1) election.

When a client has multiple business interests, estate planners should determine whether the client's interest in each business will meet the 20 percent threshold and be careful not to fall below it. In addition, attorneys should be consistent when applying valuation adjustments across multiple business interests and avoid being overly aggressive when appraising business interests for 6166 purposes.

The 6166(b)(7) Election

Twenty percent capital requirement. By making an election under Subsection 6166(b)(7) (the 6166(b)(7) election), an estate can attribute the business interests owned by a decedent's family members to the decedent. The 6166(b)(7) election can be useful in meeting the 20 percent capital requirement. With a 6166(b)(7) election, an estate can pay the estate taxes due on the decedent's business interests in 10 annual installments beginning on the

payment date, but there's no interest-only deferral period.[23]

Example 5: A decedent dies owning a 15 percent interest in ABC Partnership. The partnership doesn't meet the 45 member requirement. The decedent's sister also owns a 15 percent interest in ABC Partnership. The estate can make a 6166(b)(7) election and combine the sister's interest with the decedent's interest to meet the 20 percent capital requirement. If the value of the decedent's 15 percent interest in ABC Partnership passes the 35 percent test, then the estate can qualify for a 6166(b)(7) election and pay estate tax in 10 annual installments beginning on the payment date.

Aggregation through attribution. The 6166(b)(7) election can also be useful in meeting the 20 percent threshold. As noted above, the estate can aggregate two or more closely held businesses under Section 6166(c), but to make a 6166(a)(1) election, the estate must meet the 20 percent threshold for each separate business. If instead, the estate makes a 6166(b)(7) election, the estate alone can attribute the business interests of the decedent's family members to the decedent for purposes of meeting the 20 percent threshold, thereby allowing for 6166(c) aggregation. If the 20 percent threshold isn't met by the estate alone but is met with family attribution, then the estate can elect under Section 6166(b)(7) to pay the federal estate tax in 10 annual installments beginning on the payment date.[24]

Example 6: A decedent dies owning a 16 percent interest in both ABC Partnership and DEF Partnership. The decedent's interest in each partnership doesn't pass the 35 percent test. After cumulative 25 percent adjustments, the decedent's interest in each partnership is valued at 12 percent of the entire partnership. Therefore, the interest in each partnership doesn't meet the 20 percent threshold. However, the decedent's family members collectively own interests valued after adjustments at 10 percent of each partnership. With family attribution, the estate's interests in each of the two partnerships will meet the 20 percent threshold. The estate will be entitled to aggregate the decedent's interests in ABC Partnership and DEF Partnership to meet the 35 percent test.

There's one inherent problem in combining a 6166(b)(7) election with 6166(c) aggregation. If any business interest requires family attribution under Section 6166(b)(7), then aggregating such interest with any other interest that qualified under Section 6166(a)(1) will cause such 6166(a)(1) business interests to lose the 5-year interest-only period. For this reason, estate planners must carefully consider whether to use Section 6166(b)(7) family attribution for smaller business interests when aggregating a decedent's business interests under Section 6166(c). In certain situations, it may be better to forego deferring the estate tax on business interests that require family attribution and to aggregate only those interests that meet the 20 percent threshold on their own. The business interests owned by each decedent need to be analyzed carefully to decide which approach will ultimately yield the best result for the estate. When planning lifetime gifts, relinquishing business interests that will require a 6166(b)(7) election can also be advantageous.

It's important to distinguish between readily tradeable assets used in the business and passive assets that will be disregarded for Section 6166 purposes.

The 6166(b)(8) Election

In general, any assets held in a multi-tiered structure are deemed to be passive. Fortunately, an exception (the 80 percent exception) exists for a closely held holding corporation that holds underlying closely held corporations. If 80 percent of the assets of an underlying corporation (an underlier) are part of a trade or business, then the holding corporation and each underlier are deemed to be one entity for purposes of the 6166(a)(1) election. Any underlying corporation that doesn't meet the 80 percent exception is deemed to be passive.[25]

If too many underlying corporations fail the 80 percent exception, then an estate can make an

SHARE this article Click for more ESTATE PLANNING

election under Subsection 6166(b)(8) (a 6166(b)(8) election) for the holding corporation. The estate will then be deemed to own the underlying corporations directly, even if they fail the 80 percent exception.[26] If the estate makes a 6166(b)(8) election, and if both the holding corporation and all of the underlying corporations are "non-readily tradeable," then the estate can pay the estate tax on the holding corporation stock in 10 annual installments, beginning on the payment date.[27] If any of the stock in the holding corporation or underlying corporations is "readily tradeable," then the estate will be limited to five annual installment payments, beginning on the payment date. In this context, it's important to distinguish between readily tradeable assets used in the business and passive assets that will be disregarded for Section 6166 purposes.

It isn't clear whether the 6166(b)(8) election applies only to corporations and excludes multi-tiered partnerships and LLCs. Commentators have asserted that the 6166(b)(8) election should apply to all types of business entities.[28] To date however, no modification of the statute or the regulations thereunder has been issued. Attorneys need to be aware of this when creating family LLCs for planning purposes. Family LLCs are often combined with grantor retained annuity trusts (GRATs) to transfer family business assets. There's always a mortality risk with a GRAT. If a client dies during the annuity term, business assets that could have qualified for Section 6166 deferral may no longer qualify because they're now held in a multi-tiered LLC structure. It's important to discuss this risk with clients before creating such a structure.

Unless the spouse, the spouse's agents and/or the spouse's employees actively participate in the business, the surviving spouse's estate may not qualify for 6166 deferral.

The 6166(b)(10) Election

If the decedent owns stock in a qualifying lending and finance business, then an election under Subsection 6166(b)(10) may allow an estate to pay estate taxes in five equal annual installments beginning on the payment date.[29] This election is rarely used given the specific nature of the assets involved.

Surviving Spouses

Often, the spouse of a closely held business owner doesn't have any active involvement in the business. If the business passes outright to the surviving spouse on the death of the business owner, such business assets will qualify for a marital deduction, and no estate tax will be due on such property on the owner's death. However, on the subsequent death of the surviving spouse, unless the spouse, the spouse's agents and/or the spouse's employees actively participate in the business, the surviving spouse's estate may not qualify for 6166 deferral.

Estate planners can avoid the foregoing situation by placing the owner's business interests in a qualified terminable interest property (QTIP) trust.[30] Estates with business assets in QTIP trusts can elect 6166 deferral on the death of the surviving spouse.[31] If the predeceased spouse's estate could have made a 6166 election with regard to such business assets, then the business assets in the QTIP trust will also qualify for 6166 deferral in the spouse's estate so long as there's no material change in the form or operation of those assets.[32]

Example 7: A decedent dies owning a 50 percent interest in a closely held business. All of the decedent's interest in the business passes outright to the surviving spouse. The decedent's business partner will run the business. Unless the surviving spouse actively participates in the business, or the business partner is acting as the surviving spouse's agent, the surviving spouse's interest may not qualify for federal estate tax deferral under Section 6166.

Example 8: Same facts as in Example 7, but the decedent's business interests pass into a QTIP trust for the surviving spouse. If the decedent's estate could have elected Section 6166 deferral at the time of the decedent's death, then absent any material changes to the business during the surviving spouse's lifetime, the interest held by the

QTIP trust will qualify for Section 6166 deferral on the surviving spouse's death.

Given the results discussed above, estate planners should consider leaving closely held business interests in a QTIP trust for a surviving spouse if the surviving spouse won't actively participate in the business following the death of the decedent.

When used properly, Section 6166 is an extraordinarily powerful tool. By carefully considering the nuances of Section 6166, estate planners can ensure that clients have a tax efficient path to maintaining and growing a closely held business for future generations.[33]

Endnotes

1. Internal Revenue Code Section 6166(a)(1).
2. IRC Section 2001(a).
3. IRC Section 2031(a).
4. IRC Section 6075(a).
5. IRC Section 6166(d).
6. Section 6166(b)(1).
7. *See* Revenue Ruling 2006-34, in which the Internal Revenue Service includes limited liability companies in the analysis for Section 6166 purposes. *See also* Private Letter Ruling 200340012 (Oct. 3, 2003) and PLR 201343004 (July 17, 2013).
8. *See supra* note 6.
9. Section 6166(b)(2)(D) mandates that all of the partnership interests and stock held by the decedent or any member of the decedent's family under IRC Section 267(c)(4) (which includes the decedent's spouse, siblings, ancestors and lineal descendants) shall be treated as owned by the decedent.
10. Section 6166(b)(2)(B).
11. Section 6166(b)(2)(C).
12. Sections 6166(a)(1) and 6166(b)(2)(A).
13. Rev. Rul. 59-60.
14. Section 6166(b)(9)(A).
15. *Ibid.*
16. *Ibid.*
17. Rev. Rul. 2006-34. Rev. Rul. 2006-34 superseded Rev. Rul. 75-365, in which the IRS declared that the decedent's management of commercial and farm properties was merely investment activity and not sufficiently active for purposes of Section 6166.
18. *See supra* note 5.
19. Section 6166(a)(1).
20. Section 6166(a)(3) permits the executor to elect to make the first installment of estate tax on the fifth anniversary of the payment date. If the executor has elected to pay the deferred estate taxes over 10 installments, the last installment will be due 14 years after the payment date.
21. Section 6166(c).
22. *See supra* note 10.
23. Section 6166(b)(7).
24. *Ibid.*
25. Section 6166(b)(9)(B)(ii).
26. Section 6166(b)(8)(A)(i).
27. Section 6166(b)(8)(B).
28. Louis A. Mezzullo, *Planning to Pay Estate Taxes* (2005); Dennis I. Belcher and William I. Sanderson, *Estate Planning for the Closely Held Business* (2010).
29. Section 6166(b)(10).
30. Such marital bequests may be pre-residuary or residuary in nature.
31. Treasury Regulations Section 20.2044-1(b).
32. PLR 200521014 (May 27, 2005).
33. A discussion of the 6166 notice of election, 6166 annual computations, Section 6324A special liens, state 6166 elections and other topics related to administering 6166 estates will be discussed next month in a follow up to this article.

SPOT LIGHT

Jungle Fever

"Panthère" by Gabriel Alix, sold for $11,494 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017. A Haitian artist, Alix moved from his native Saint Marc to Port-au-Prince, the capital, to join the Centre d'Art. His best known paintings depict daily life scenes, jungle imagery and still life subjects.

SHARE this article
Click for more ESTATE PLANNING

By **Terry LaBant**

Where Does Your Trust Live?

How to minimize state income taxes

State income tax laws have become much more complicated for trusts. Trusts can become subject to tax in multiple states based on the random intersection of various state laws. It's important for estate planners to understand the key principles that drive state trust income taxation and methods to plan ahead for minimizing them. Ideally, effective state income tax planning will help advisors add value to the key family relationships they've developed with the plans they originally created for transfer tax planning purposes.

Change in Focus

In the 1990s, during the early half of my career, I focused client discussions on the areas of estate and wealth transfer tax planning. These conversations arose while exemption amounts remained lower than today and the tax rates remained higher. Income tax planning rarely surfaced. With the Bush Tax Act era,[1] exemption amounts rose, and many states decoupled from the federal estate tax system. The estate tax went away (sort of) for a year, and that greatly benefited a few billionaire families whose patriarch had died. Then, the $5 million exemption appeared, which remains adjusted for inflation at $5.49 million this year.[2] Today, less than 1 percent of families are now subject to the estate tax.

As a result, the overall planning focus has shifted more toward the income tax side of the Tax Code. For years, tax professionals could help their clients by reading a tax return from back to front. Deductions taken on later schedules would provide meaningful benefits and lower taxes due on Page 2 of individual returns.

Then, along came the American Taxpayer Relief Act of 2012 (the Act).[3] This current Act remains a bit of a misnomer because every working individual now pays more income tax under this Act than before. It created four different ways to define a "wealthy" taxpayer at the bottom of Page 1 of an individual return. It's been increasingly more difficult for taxpayers to lower their taxes due on Page 2 once they trigger their wealthy taxpayer status on Page 1.[4]

Both the Republican Party[5] and President Donald J. Trump have proposed income tax reform designed to simplify tax brackets and corresponding rates while lowering deduction opportunities for the average taxpayer.[6]

As a result, state income tax planning has become more relevant than ever. Individuals can take advantage of better income tax rates simply by migrating from one state to another. These effects can prove meaningful.[7]

Five Factors

The easiest way for an individual taxpayer to migrate from one state to another begins with selling his home and moving altogether. With proper planning, though, individuals also can retain homes in more than one state, yet choose their state of residence and pay lower (or no) taxes.[8]

State income tax laws generally measure days of residence within a state and a combination of facts and circumstances to determine residence. States increasingly use their income tax department for audits to retain needed tax dollars when former residents place one foot firmly in a new state while dragging the other foot behind in their prior home state.[9]

By comparison, states examine five key factors to determine whether they'll collect income tax from a trust. These factors focus on the location of the:

Terry LaBant is vice president and a senior wealth strategist at Calamos Wealth Management LLC in Chicago

- Grantor (when the trust becomes irrevocable);
- Trust assets;
- Trustees;
- Trust administration; and
- Trust beneficiaries.

States then take different approaches to weigh these factors when taxing a trust. Some states will tax a trust that triggers only one factor. Other states will tax a trust that triggers multiple factors.

For a comprehensive review of the various underlying state laws behind these approaches, Richard W. Nenno of Wilmington Trust Company has put forth extensive discussions beyond the scope of this article.[10] For a brief overview, "Taxation of Trust Income," p. 22, shows which states do and don't tax trust income.[11]

Inconsistency Among State Laws

The state tapestry illustrations that follow highlight the inconsistency among state laws affecting trust income taxation. This inconsistency can sometimes create circumstances in which a trust maintains contact with several states but pays no state income tax. More often, though, this inconsistency can subject a trust to income tax in several different states at once.

In a perfect world, planners would draft new trusts for clients who could control the various state contacts and avoid more of these state income taxes. In our less perfect world, though, there remain options for planners to minimize state income taxes for trusts as they arise.

Let's look at the various techniques planners can use to avoid exposure to the five key factors that may trigger state trust income taxes.

Grantor Residency

This factor remains the source of controversy and increasing court litigation over the past several years. For example, at one time, Illinois forever would tax an irrevocable trust created by a then-Illinois resident.[12] In *Linn v. Department of Revenue*,[13] a prominent Illinois family successfully challenged the constitutionality of this approach. Other taxpayers have brought similar cases in other states based on constitutional grounds.[14]

Although these challenges have narrowed some state laws, they remain alive and well in other states today. A few years ago, 11 states taxed a trust based on grantor residency alone, and seven other states taxed based on this factor along with others.[15] By last year, the numbers of states taxing on this factor alone or in conjunction with others had changed to seven and 18 respectively.[16]

Assume a client is currently a resident of Illinois but already spends part of the winter season in Florida. If the client created an irrevocable (non-grantor) gift trust as an Illinois resident, it would be subject to Illinois state income tax. If the client moved and established primary residency in Florida and then created the trust, it wouldn't be subject to income tax on that basis alone.

> If trust assets become subject to state income tax, the trustee should simply move them to another state.

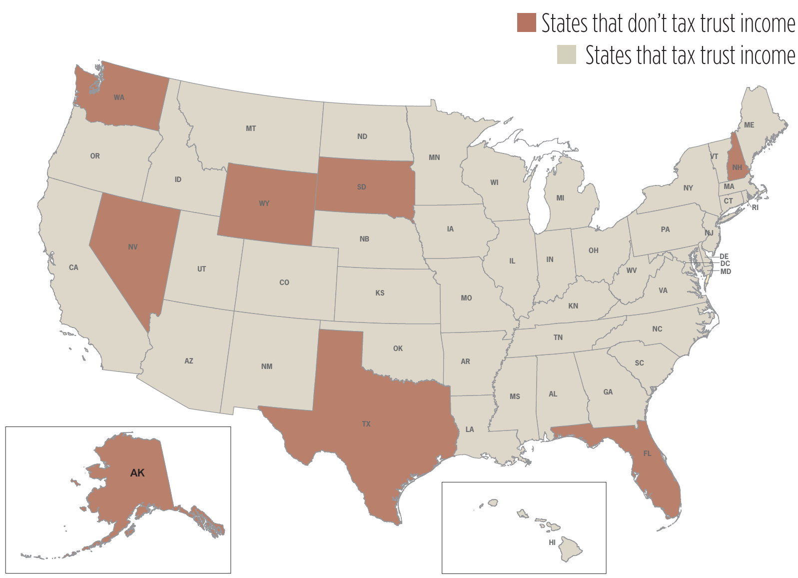
Now assume a client is currently a resident of Illinois but already has created an irrevocable gift trust AND now plans to move to Florida. As a grantor trust, this gift trust wouldn't be an Illinois resident trust. The client therefore could move from Illinois to Florida and then release the grantor trust power(s). It then would become a Florida resident trust that isn't subject to income tax.

As a non-grantor trust, it could remain subject to tax as an Illinois resident trust even after the client's Florida move. *Linn* provides a roadmap to disconnect such a trust from Illinois, but keep in mind that decision ended at the appellate court level. Also, note that *Linn* involved a Texas trust created through a power of appointment (POA) that had no ties to Illinois from its inception.

Are there any planning opportunities to cure the

Taxation of Trust Income

Different state approaches



— *Terry LaBant*

original Illinois irrevocable gift trust taxation if it remained subject to Illinois tax? The client could create a new irrevocable gift trust to hold future gifts after the move.

The client also could decant the original Illinois gift trust by moving its assets to a new:

- Non-resident trust;
- Traditional grantor trust; or
- (Non-resident) beneficiary as grantor trust.

For this purpose, the trustee, an appointing person or trust protector would be involved to handle the decanting process.

If the client needs to create an Illinois trust now and move to Florida later, the grantor also could retain the power to amend or revoke the trust or retain a general POA to release later. Again, the trust wouldn't be subject to Illinois tax if it would become irrevocable after the client's move to Florida or if it would become a non-grantor trust after that move.

Trust Assets

If trust assets become subject to state income tax, the trustee should simply move them to another state. This tactic works great for intangible assets or tangible assets the trustee can move physically, such as artwork or collectibles. It also helps if the trust permits the trustee or trust protector to move the trust situs and its underlying property to another jurisdiction.

What if the trust owns real estate? The trustee could sell the real estate and invest the proceeds in another state that doesn't tax trusts based on the location of its assets.

The trustee also could convert real property to intangible property by transferring it into a business entity formed in another state. An attorney would then need to review the state income tax laws governing entities in each state to determine whether that transfer would relocate the entity's tax residence effectively.

Trustees

If a trust becomes subject to income tax based on the trustee's state of residence, the trustee could move to another state to cure the problem. With corporate trustees, this could be easier to accomplish than with individual trustees.

An individual trustee could decline to act if appointed or resign if already acting. The trustee declination or resignation could be temporary and allow the trustee to act in the future should his state of residence or underlying state laws change.

Trustee removal and replacement provisions are helpful to solve this particular problem when a trustee isn't willing to step down to solve the state tax problem.

Trust Administration

If a trust becomes subject to income tax based on the

trust's state of administration, the trustee should move administration to another state. This obvious move becomes difficult for individual trustees or local, community corporate trustees. In that event, a change of trustees in line with the preceding discussion would help.

Before concluding that a change of trustee is necessary, however, first review the state laws to determine what constitutes "administration." It may be easier to fall outside the state definition of "administration" than to change trustees altogether. For instance, if trust administration is determined by the location of custodial accounts, the administration could be moved accordingly.

Some trusts permit the trustee or a trust protector to move the situs of the trust administration and underlying property to another jurisdiction. This move could be sufficient to avoid state trust income tax without the need to change trustees. See "Taxes Based on State of Administration," p. 24.

Trust Beneficiaries

When clients create gift trusts, they often favor a spray trust instead of separate sub-trusts or trust documents. They have the impression that attorneys create separate documents to drive fees, but the separate trusts or shares can provide planning opportunities as beneficiaries move around the country.

If a spray trust has beneficiaries who move to a state that taxes trust income on that basis, it could taint all trust income earned by that trust. A separate gift trust or separate share would help isolate the income otherwise subject to state tax based on a beneficiary's residence.

If this issue arises within an existing trust, consider the ability to create separate shares within the trust document. If that option isn't available, consider decanting options to create multiple new trusts or one new trust with separate shares to isolate the state income tax effect following beneficiary moves.

SHARE this article | Click for more ESTATE PLANNING

As a last resort, a beneficiary could disclaim a trust interest altogether. That may only work practically in a case in which the beneficiary remains independently wealthy or has access to other family trust benefits that don't trigger this problem to the same degree.

Creative Solutions

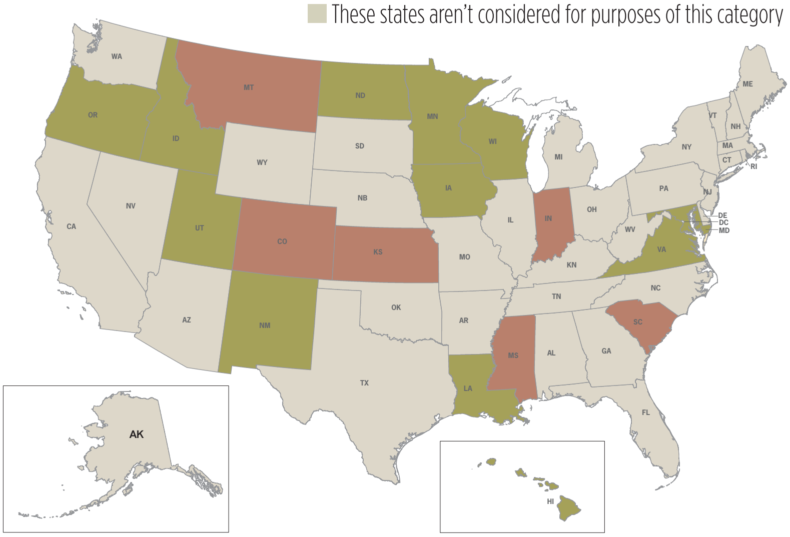
State trust income tax laws vary widely and assess tax based on multiple factors. These separate and overlapping factors and laws easily create situations in which trust income becomes subject to tax in several states.

As our client base ages and more living trusts become irrevocable, these state tax problems will become more common. This will prove especially true among families that live across the country and often serve as beneficiaries and trustees.

Attorneys and advisors can create great value by helping clients track these tax matters effectively and applying creative solutions to help minimize the costs to them.

Taxes Based on State of Administration

A survey of 50 states and Washington, D.C.



— *Terry LaBant*

Endnotes

1. Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub.L. 107–16, 115 Stat. 38, June 7, 2001).
2. American Taxpayer Relief Act of 2012 (Pub.L. 112–240, H.R. 8, 126 Stat. 2313, enacted Jan. 2, 2013).
3. *Ibid.*
4. *Ibid.*
5. Paul Ryan and Kevin Brady, *A Better Way for Tax Reform* (White Paper) (2016), *https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-Snapshot.pdf.*
6. Terrence M. LaBant, *Income Tax Reform: Party Line vs. Presidential Politics* (White Paper) (2017), *www.calamos.com/~/media/documents/wm/2017/income-tax-reform-party-line-vs-presidential-politics.pdf.*
7. Terrence M. LaBant, "For Snowbird Tax Savings, Avoid Homing Pigeon Instincts," *Estate Planning* (June 2016), at pp. 11-14.
8. *Ibid.*
9. *Ibid.*
10. Richard W. Nenno, "State Income Taxation of Trusts," 869 *Tax Mgmt. Port* (2013).
11. Richard W. Nenno, "Bases of State Income Taxation of Nongrantor Trusts," Lecture, American College of Trust and Estate Counsel (2016).
12. 35 Ill. Comp. Stat. 5/201(a), (b)(5),(c),(d), 5/1501(a)(20)(C)–(D); Ill. Admin. Code Tit. 86, Section 100.3020(a)(3)–(4); instructions to 2015 Form IL- 1041 at 4; 2015 Form IL-1041 at 2, 3.
13. *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013).
14. *Comptroller of the Treasury of Maryland v. Wynne*, 135 S.Ct. 1787 (2015); *Bank of America, N.A. v. Commissioner*, 474 Mass. 702 (2016); *Residuary Trust A v. Director*, 27 N.J. Tax 68 (Tax Ct. 2013); *The Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Dep't of Rev.*, No. 12 CVS 8740, 2015 WL 1880607 (N.C. Sup. Ct., 2015); *McNeil v. Commonwealth of Pennsylvania*, PA Comm. Court, No. 651 FR 2010, 173 FR 2011 (2013). *See also* James H. Cundiff, "State Income Tax Considerations and Current Income Tax Legislation," Lecture, The Delaware Bankers Association (2016).
15. Christine Albright, "State Income Taxation of Trusts—Fifty-One Different Stories and a Few Surprise Endings," Lecture, Chicago Estate Planning Council (2012).
16. *Supra* note 11.

By **Terence Condren**

Selecting the Optimal Term for a QPRT

Maximize the retained interest and minimize the risk of dying

A qualified personal residence trust (QPRT) can be a tax-efficient way of transferring a primary residence or vacation home to the next generation. Designing an effective QPRT involves making many important and complex decisions, but selecting the initial term of the QPRT may be the most critical. The longer the term, the greater the risk the grantor will die during the term, and the QPRT won't achieve any estate tax savings. If the term is too short, then the QPRT will generate lower estate tax savings than it could have delivered had the term been longer. Here's one method for calculating the mathematically optimal term of a QPRT.

Planning Strategy Overview

A QPRT[1] is an irrevocable trust that allows a taxpayer to transfer a personal residence to the next generation for less than the full value of the residence by creating three distinct interests in the residence:

1. **An income interest**, which is the right to live in the house for a fixed term of years or until the grantor's death, whichever comes first;
2. **A reversion interest**, which is the right to receive the house if the grantor fails to survive the fixed term of years; and
3. **A remainder interest**, which is the right to receive the house if the grantor survives the fixed term of years.

The grantor retains the income and reversion interests, so the only thing that the grantor gives away is the remainder interest, which is always worth less than the full value of the residence. The value of the remainder interest counts against the grantor's lifetime gift/estate tax exemption, which is $5.49 million in 2017.[2] The federal estate tax is currently 40 percent,[3] so for taxpayers who are wealthy enough to trigger the estate tax, each $1,000 of exemption is worth $400 of tax savings. A lower QPRT remainder interest uses less exemption, which in turn results in a lower estate tax.

The values of these three interests are based on three key factors:

1. **Fixed term of years:** The term of years must be written into the trust document and can't be changed.
2. **Grantor's age when the QPRT is funded:** The grantor's age is calculated as of the date the grantor transfers the residence to the QPRT and then rounded to the nearest whole number.[4]
3. **Interest rate used to represent the time value of money:** The interest rate (the Internal Revenue Code Section 7520 rate) is published monthly by the Internal Revenue Service,[5] and the IRC Section 7520 rate in effect when the grantor funds the QPRT is the rate used for the calculations.

Example: Pat, age 60, owns a $1 million vacation home and wants to pass it down to his children. An outright gift of the home would use $1 million of Pat's lifetime gift tax exemption.[6] If Pat were to transfer the home to a 20-year QPRT in January 2017, however, he would use only $361,030 of his lifetime gift tax exemption. Compared to the outright gift approach, the QPRT will save Pat an additional $255,588 in estate tax.[7] It's interesting to note that this is the estate tax savings regardless of how much the home appreciates after the transfer is made because that savings would occur regardless of whether the home is gifted outright or through a QPRT.

Terence Condren is a senior wealth strategist and part of the Advanced Planning Group with UBS Financial Services Inc. in Boston

Determining the Optimal Term

The only one of the three key variables that the grantor can control is the length of the fixed term of years, so the key to calculating the optimal term of a QPRT is figuring out which term of years creates the best tradeoff between reward and risk.

Reward: As the term of a QPRT increases, the values of the retained interests (that is, the income and reversion interests) increase, and the taxable gift produced by the QPRT declines. A longer term creates a more valuable income interest because the right to live in a house for 20 years is worth more than the value to live in that house for 10 years. A longer term also increases the value of the reversion interest because the grantor has a higher probability of dying during a 20-year term than during a 10-year term. The higher the value of the retained interests, the less gift/estate tax exemption the grantor uses, which in turn increases the estate tax savings that the grantor will realize from the QPRT, assuming he survives the term (see below).

Risk: As the term of a QPRT increases, the probability of the grantor surviving the term drops. If the grantor dies during the term of the QPRT, the entire value of the residence will be included in the grantor's estate for estate tax purposes, and the grantor won't recognize any estate tax savings.

Based on those factors, the question then becomes what term produces the largest value of retained interests (reward) as adjusted by the mortality probability (risk)? One way to answer this question is:

1. Start with a short term of years for the QPRT that the grantor is very likely to survive.
2. Calculate the gift (that is, remainder interest) produced by that term given the grantor's age and the Section 7520 rate.[8]
3. Subtract the gift from the full value of the residence to calculate the retained interests (that is, the reward).
4. Multiply the retained interests by the probability that the grantor will survive the term of years (that is, the likelihood of realizing the reward).[9]
5. Write the product down, increase the term by one year and then repeat the process. Continue until the product is lower than the previous product. At that point, the term associated with the previous product is the optimal term. The results of that exercise for our hypothetical client Pat are shown in "Optimal Number of Years for a QPRT," this page.

If you knew exactly when a client would die, the optimal QPRT term would end the day before death. Because we can't know when a particular client will pass away, multiplying the value of the retained interest created by a selected term by the actuarial probability of surviving that term allows us to calculate the risk-adjusted benefit of the QPRT.

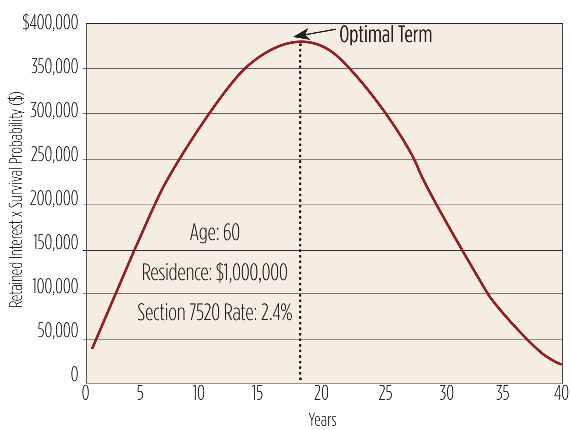
Making these calculations for a single client at a specific point in time is a little tedious, but it's not horrendous. "Optimal Term Table," p. 28, however, shows the optimal term for a QPRT based on the methodology described above for any combination of age (40 to 80) and Section 7520 rate (1.0 percent to 5.0 percent). Because the survival probability is based on a unisex life expectancy table, consider adding a few years for a female grantor and subtracting a few years for a male grantor. Of course, you may wish to make further adjustments based on the grantor's specific medical circumstances and family longevity history.

Drawbacks and Alternatives

Although a QPRT can be an effective way to pass a residence to the next generation at a heavily discounted value, the technique does present several drawbacks.

Optimal Number of Years for a QPRT

Multiply the value of the retained interest created by a selected term by the actuarial probability of surviving that term



— *Terence Condren*

Note that the following list isn't exhaustive:

1. If the grantor fails to survive the term, even if only by a single day, the residence is included in the grantor's estate at its date-of-death value.[10] This "mortality risk" can be offset by purchasing a life insurance policy on the grantor's life and holding that policy in an irrevocable life insurance trust, assuming that the grantor is insurable.
2. A QPRT is a poor choice for generation-skipping transfer (GST) tax planning because the grantor can't allocate GST tax exemption to the QPRT until after the fixed term of years has expired.[11] By that time, the value of the residence is likely to have increased, and the allocation of GST tax exemption would have to be made based on the fair market value of the residence at that time.
3. If the grantor decides to downsize the house during the term of the QPRT, then the excess cash must be returned to the grantor either outright or in the form of a grantor retained annuity trust.[12] Either alternative will diminish the QPRT's expected estate tax savings.
4. A mortgaged property is generally considered a poor choice for QPRT planning because a mortgage payment by the grantor may be treated as an additional gift to the remainder beneficiaries. This payment would use additional gift tax exemption and would necessitate the annual filing of a gift tax return.
5. If, as a result of future changes to the estate tax laws, the grantor doesn't end up facing an estate tax and would have otherwise received a step-up in the tax basis of the residence at death, then the QPRT strategy will have increased the family's overall tax burden rather than reduced it.

An alternative to the QPRT strategy that addresses those drawbacks is to sell the residence to an irrevocable grantor trust. With this approach, the grantor creates an irrevocable trust that's taxed as a grantor trust, often by retaining the right to substitute assets for other assets of equivalent value.[13] No gain will be recognized on the sale of the house to the trust because the grantor and the trust are considered to be the same person for income tax purposes.[14] The grantor then sells the residence to the trust in exchange for a low interest note and leases the house from the trust, paying fair market rent. This strategy doesn't have a mortality risk, can harness the grantor's GST tax exemption, provides for great flexibility if the house is sold in the future and allows the grantor to reacquire the home in exchange for cash or other high basis property if there's an opportunity to get a step-up in the house's tax basis at the grantor's death. On the downside, the strategy is more susceptible to audit risk than a QPRT, and it freezes the value of the income interest and the reversion interest in the grantor's estate rather than completely erasing the value of those interests.

The Optimal Balance

Getting the maximum benefit out of a QPRT requires striking an efficient balance between maximizing the retained interests and minimizing the risk of dying during the term of the QPRT. Every client presents a unique situation, but we can calculate the standard optimal balance between reward and risk and use that result to start off on the right path.

Endnotes

1. Treasury Regulations Section 25.2702-5(c).
2. Revenue Procedure 2016-55, Section 3.35.
3. Internal Revenue Code Section 2001(c).
4. Treas. Regs. Section 25.2512-5(d) ("... the annuitant is 68 years and 5 months old. The donee annuitant's age is treated as 68 for purposes of computing the present value of the annuity" and "... the donor is 59 years and 6 months old. The donor's age is deemed to be 60 for purposes of computing the present value of the retained annuity.")
5. Treas. Regs. Section 25.2512-5(a).
6. This example doesn't take the annual gift tax exclusion amount of $14,000 per donor per donee into account.
7. ($1 million - $361,030) = $638,970 of estate exemption saved, multiplied by the federal estate tax rate of 40 percent, equals $255,588.
8. This calculation can be done by manually using voluminous tables published by the Internal Revenue Service (*www.irs.gov/retirement-plans/actuarial-tables*), but most people today use software such as NumberCruncher or TigerTables.
9. There are many different mortality tables. For qualified personal residence trust calculations, the IRS uses Table 2000CM (*www.irs.gov/retirement-plans/actuarial-tables*), and this article uses the same table for convenience. The drawbacks to using Table 2000CM are that it's based on old life expectancy data and it's unisex, so it doesn't account for the fact that females have a higher life expectancy than males.
10. IRC Section 2036(a)(1).
11. IRC Section 2642(f).
12. Treas. Regs. Section 25.2702-5(c)(8).
13. IRC Section 675(4).
14. IRC Section 675. *See also* Revenue Ruling 85-13.

Optimal Term Table

Combining age and the Internal Revenue Code Section 7520 rate

	IRC Section 7520 Rate																				
Age	1.0%	1.2%	1.4%	1.6%	1.8%	2.0%	2.2%	2.4%	2.6%	2.8%	3.0%	3.2%	3.4%	3.6%	3.8%	4.0%	4.2%	4.4%	4.6%	4.8%	5.0%
40	36	35	35	34	33	33	32	32	31	31	31	30	30	29	29	29	28	28	28	28	27
41	35	35	34	33	33	32	32	31	31	30	30	30	29	29	28	28	28	28	27	27	27
42	35	34	33	33	32	31	31	30	30	30	29	29	29	28	28	28	27	27	27	26	26
43	34	33	32	32	31	31	30	30	29	29	29	28	28	28	27	27	27	26	26	26	26
44	33	32	32	31	31	30	30	29	29	28	28	28	27	27	27	26	26	26	26	25	25
45	32	31	31	30	30	29	29	28	28	28	27	27	27	26	26	26	26	25	25	25	25
46	31	31	30	30	29	29	28	28	27	27	27	26	26	26	25	25	25	25	24	24	24
47	31	30	29	29	28	28	27	27	27	26	26	26	25	25	25	25	24	24	24	24	23
48	30	29	29	28	28	27	27	26	26	26	25	25	25	25	24	24	24	24	23	23	23
49	29	28	28	27	27	27	26	26	25	25	25	24	24	24	24	23	23	23	23	23	22
50	28	28	27	27	26	26	25	25	25	24	24	24	24	23	23	23	23	22	22	22	22
51	27	27	26	26	25	25	25	24	24	24	23	23	23	23	22	22	22	22	22	21	21
52	27	26	26	25	25	24	24	24	23	23	23	23	22	22	22	22	21	21	21	21	21
53	26	25	25	24	24	24	23	23	23	22	22	22	22	21	21	21	21	21	20	20	20
54	25	25	24	24	23	23	23	22	22	22	22	21	21	21	21	20	20	20	20	20	20
55	24	24	23	23	23	22	22	22	21	21	21	21	20	20	20	20	20	20	19	19	19
56	23	23	23	22	22	22	21	21	21	21	20	20	20	20	19	19	19	19	19	19	18
57	23	22	22	22	21	21	21	20	20	20	20	19	19	19	19	19	19	18	18	18	18
58	22	22	21	21	21	20	20	20	20	19	19	19	19	18	18	18	18	18	18	18	17
59	21	21	20	20	20	20	19	19	19	19	18	18	18	18	18	18	17	17	17	17	17
60	20	20	20	19	19	19	19	18	18	18	18	18	17	17	17	17	17	17	17	16	16
61	20	19	19	19	19	18	18	18	18	17	17	17	17	17	17	16	16	16	16	16	16
62	19	19	18	18	18	18	17	17	17	17	17	16	16	16	16	16	16	16	15	15	15
63	18	18	18	17	17	17	17	17	16	16	16	16	16	16	15	15	15	15	15	15	15
64	17	17	17	17	17	16	16	16	16	16	15	15	15	15	15	15	15	15	14	14	14
65	17	16	16	16	16	16	16	15	15	15	15	15	15	14	14	14	14	14	14	14	14
66	16	16	16	15	15	15	15	15	15	14	14	14	14	14	14	14	14	13	13	13	13
67	15	15	15	15	15	14	14	14	14	14	14	14	13	13	13	13	13	13	13	13	13
68	15	14	14	14	14	14	14	14	13	13	13	13	13	13	13	13	12	12	12	12	12
69	14	14	14	13	13	13	13	13	13	13	13	12	12	12	12	12	12	12	12	12	12
70	13	13	13	13	13	13	12	12	12	12	12	12	12	12	12	12	11	11	11	11	11
71	13	12	12	12	12	12	12	12	12	12	11	11	11	11	11	11	11	11	11	11	11
72	12	12	12	12	12	11	11	11	11	11	11	11	11	11	11	11	10	10	10	10	10
73	11	11	11	11	11	11	11	11	11	10	10	10	10	10	10	10	10	10	10	10	10
74	11	11	11	10	10	10	10	10	10	10	10	10	10	10	10	10	9	9	9	9	9
75	10	10	10	10	10	10	10	10	9	9	9	9	9	9	9	9	9	9	9	9	9
76	10	9	9	9	9	9	9	9	9	9	9	9	9	9	9	9	9	8	8	8	8
77	9	9	9	9	9	9	9	9	8	8	8	8	8	8	8	8	8	8	8	8	8
78	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	7
79	8	8	8	8	8	8	8	8	8	7	7	7	7	7	7	7	7	7	7	7	7
80	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7

— Terence Condren

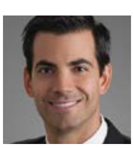
By **Wesley L. Bowers**

Decoding the Deduction

What's the right form to use for professional fees?

Given our current tax environment, more and more estate planning and administration professionals are diving (often times, reluctantly) into the abyss of the income tax world. One of the more frequent questions asked by attorneys, CPAs and other professionals during an estate administration is: "Where should we deduct professional fees (attorney, CPA, appraisal, etc.): on Form 706 or Form 1041?" What seems like a simple question at first blush is often extremely complicated and takes you through a labyrinth of decision trees, regulations and case law.

The traditional answer of where to deduct professional fees was often to deduct them on Form 706, simply because more estates were subject to the estate tax in prior years when the exemptions were significantly lower, and the estate tax rate was traditionally much higher than an estate's income tax rate. Now, however, this question has become even more complicated to answer due in large part to the proximity between the effective estate tax rate (currently, 40 percent) and an estate's income tax rate (currently, a top bracket of 39.6 percent, with a potential 3.8 percent net investment income tax). In addition, the introduction of portability has changed the traditional estate-planning model, and more estate tax returns are now filed when not otherwise required to take advantage of the portability features. With so many recent changes and a myriad of possible planning structures, it's no wonder many are confused as to how to answer a seemingly simple question: "Where should I deduct attorney's fees?"



Wesley L. Bowers is a shareholder with Fizer Beck P.C. in Houston

Deduct on Form 706 or 1041

In general, deductions that are allowable on an estate tax return (Form 706) under Internal Revenue Code Sections 2053 (expenses and debts) or 2054 (losses) aren't also allowed as an income tax deduction on an estate's income tax return (Form 1041). Accordingly, an executor must choose to deduct most estate administration expenses on Form 706, Form 1041 or split the expenses between such two returns. If taken on one return, however, the same deduction can't be taken again on the other—no double deductions are permitted.[1] For an executor to take a deduction on Form 1041, he must file a "waiver" with Form 1041 stating such expenses haven't been allowed as deductions on the estate tax return and that all rights to have such deductions on the estate tax return are waived.[2]

Hubert Regulations

To complicate things further, a great amount of uncertainty has existed in the past regarding the impact of the deductibility of estate administration expenses on the marital and charitable deductions. The "*Hubert* regulations"[3] specify how different types of estate administration expenses reduce the marital or charitable share. The regulations provide that estate management expenses[4] (those incurred in connection with the investment of estate assets and their preservation and maintenance—for example, investment advisory fees, stock brokerage commissions, custodial fees and interest) may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. However, estate transmission expenses[5] (all other estate administration expenses that aren't estate management expenses—for example, attorney's fees, CPA fees, appraisal fees, executor commissions and

probate fees) will require a dollar-for-dollar reduction in the amount of the marital or charitable deduction if they're paid out of assets that would otherwise pass to the surviving spouse or to charity.

In addition, note that the marital or charitable deduction must also be reduced by the amount of any estate management expenses that are paid from the marital/charitable share but are attributable to a property interest not included in the marital/charitable share.[6] The marital or charitable deduction must also be reduced by the amount of any estate management expenses that are deducted under IRC Section 2053 on the decedent's federal estate tax return.[7]

Where to Deduct?

Estate management expenses (particularly those attributable to property passing to a spouse or charity) should almost always be deducted on Form 1041 if there's a large marital or charitable deduction involved. Taking the deduction on Form 706 requires a reduction of the marital/charitable deduction, with no corresponding benefit obtained through a deduction on Form 1041.

The analysis of where to deduct estate transmission expenses (for example, professional fees), however, is much more complicated, with the result depending on a variety of interlacing factors (including, among others, size of the estate, tax rates involved and the type of funding clause in the governing documents).

Decedent Isn't Survived By Spouse

If a decedent isn't survived by a spouse who inherits the estate, the analysis of where to deduct professional fees is much easier. If a decedent passes away with a taxable estate requiring the filing of Form 706 and leaves his estate to descendants or other taxable beneficiaries (for example, non-spouse or non-charity), then it's often more advantageous to deduct professional expenses on Form 706 due to the relatively higher flat estate tax rate. Also, the estate receives a current estate tax deduction as opposed to receiving a federal income tax deduction only as income is accrued. If, however, no estate tax is owed, or if the expenses to be deducted are so large as to offset any estate tax liability (which would result in some of the deduction essentially being wasted), then all or a portion of such expenses should be considered as deductions on Form 1041.

Decedent is Survived by Spouse

If a decedent is married at the time of death and leaves his estate to a surviving spouse (either outright or in trust), the analysis becomes much more complex. As estate and income tax rates are so close to one another, many tax professionals are operating under a default (and sometimes erroneous) position that at a first spouse's death, an estate comes out ahead by deducting professional fees and other estate transmission expenses on Form 1041 rather than on Form 706 (with the idea that the estate/beneficiaries will enjoy certain and current income tax savings, especially in light of the uncertainties of the estate tax). However, the prudent practitioner will analyze the various competing factors and try to ascertain the overall best course of action given the unique circumstances of each situation.

One of the more common scenarios involves an estate plan with a "true worth" pecuniary funding formula, which, on the death of a spouse, creates two shares: (1) a marital share, often distributed outright to the surviving spouse or to a marital trust for the surviving spouse's benefit; and (2) a non-marital share, which often consists of the decedent's remaining exemption amount and is usually distributed to a bypass trust for the benefit of the surviving spouse. Under this pecuniary funding formula, either the marital share or the non-marital share is defined as a fixed dollar amount (often funded with date of distribution values), and the residue of the estate is used to fund the other share, whether marital or non-marital. This formula typically freezes the amount of the pecuniary bequest at date-of-death values, while passing on increases or decreases in the value of assets that occur during the term of estate

> While you can't "double deduct" the amount of professional fees, this rule doesn't preclude you from splitting the deduction between Form 706 and Form 1041.

administration to the residuary share. Gain or loss may occur on funding the pecuniary bequest, which is often touted as the primary disadvantage of this funding method, although no gain or loss occurs when funding the residuary share.

Below are a number of hypothetical scenarios under a true worth pecuniary funding formula that illustrate the analysis of where professional fees should be deducted based on the various factors involved. Whether professional fees should be deducted on Form 706 or Form 1041 varies from example to example, based on changing circumstances.

Five Examples

Each example assumes the death of the first spouse, with all assets passing to or for the benefit of the surviving spouse. Assume for all examples that the estate tax exemption is $5 million, and each of Husband and Wife maintain their full exemption. Also for simplicity, assume for all examples that the professional fees to be deducted are attorney's fees totaling $1 million incurred during administration (wishful thinking?!) and are to be paid out of the residue of the estate.

Example 1: Pecuniary marital with residue bypass (estate is large enough to fund marital bequest). Assume Husband and Wife have a combined estate of $16 million ($8 million each owned by Husband and Wife, respectively). Husband predeceases Wife. Husband's will provides for an outright pecuniary bequest to Wife of the marital share (the largest sum possible that can pass to her without generating any estate tax, taking into account the decedent's other usage of his estate tax exemption), with the residual non-marital share (generally, the amount of the decedent's remaining estate tax exemption) passing to a bypass trust. Under these facts, there's an outright pecuniary marital deduction bequest of $3 million to Wife, with the residue ($5 million) passing to the bypass trust.

If professional fees of $1 million are deducted on Form 706, this ends up reducing the pecuniary marital bequest to Wife as reported on Form 706 (from $3 million down to $2 million). Because the amount required to fund this pecuniary marital bequest is reduced, more assets can now pass into the residuary bypass trust, as illustrated in "Form 706 Deduction: Example 1," this page.

If professional fees of $1 million are deducted instead on Form 1041, then the estate receives a current income tax deduction, but there's now a larger pecuniary marital gift that must be funded (resulting in less going to the bypass trust), illustrated in "Form 1041 Deduction: Example 1," p. 33.

The deduction may be better used on Form 706, especially if there's little income to offset the deduction, the estate's income tax bracket is very low or the bypass trust isn't anticipated to appreciate over the coming years; however, deducting these expenses on Form 1041 may yield more savings (in addition to the benefit of getting tax savings currently) if the marginal income tax bracket exceeds the estate tax rate or if the surviving spouse's estate won't be subject to estate tax (because of anticipated spending habits or future law changes, such as increases in or elimination of the estate tax exemption and/or reductions to the estate tax rate).

Form 706 Deduction: Example 1

More assets pass into the bypass trust

Estate Assets	
$8,000,000	Estate
($1,000,000)	Fees
$7,000,000	Remaining Estate

As Reported on 706	
$8,000,000	Gross Estate
($1,000,000)	Fee Deduction
($2,000,000)	Marital Deduction
$5,000,000	Taxable Estate

Funding	
$2,000,000	Pecuniary Marital
$5,000,000	Residue Bypass (Assumes No Change in Values)

Observations
No Income Tax Deduction
Larger Bypass Trust

— *Wesley L. Bowers*

Form 1041 Deduction: Example 1

Less assets pass into the bypass trust

Estate Assets	
$8,000,000	Estate
($1,000,000)	Fees
$7,000,000	Remaining Estate
As Reported on 706	
$8,000,000	Gross Estate
($3,000,000)	Marital Deduction
$5,000,000	Taxable Estate
Funding	
$3,000,000	Pecuniary Marital
$4,000,000	Residue Bypass (Assumes No Change in Values)
Observations	
Estate Receives Current Income Tax Deduction	
Smaller Bypass Trust	

— Wesley L. Bowers

Example 2: Pecuniary marital with residue bypass (estate isn't large enough to fund marital bequest, but Form 706 is filed for portability). Assume the same facts as Example 1, except that Husband and Wife have a combined estate of $8 million ($4 million each owned by Husband and Wife). Under these facts, not enough assets as of date of death are available to trigger Wife's pecuniary bequest. Instead, all assets pass to the residuary bypass trust.

If professional fees of $1 million are deducted on Form 706, this increases the amount of portability available for the survivor as reported on Form 706, as illustrated in "Form 706 Deduction: Example 2," this page.

If professional fees of $1 million are deducted instead on Form 1041, then the estate receives a current income tax deduction. The bypass trust would be larger in theory under this approach, but assets of the estate have been depleted for the $1 million in estate expenses (assuming no substantial growth of the residue). Moreover, even though there's a smaller amount for portability, the surviving spouse's estate, due to its small size, may not be able to use much, if any, of the portability when the time comes. (See "Form 1041 Deduction: Example 2," p. 34.)

Taking the deduction on Form 1041 is often more beneficial to get the current income tax deduction instead of an increased portability amount (that may never be used). **Practice note:** If the estate increases in size from date of death to date of funding, there will never be a pecuniary marital bequest, as funding values are typically set as of date of death, depending on your funding formula—all appreciation inures to the benefit of the bypass trust.

Example 3: Pecuniary bypass with residue marital (estate is large enough to fund marital bequest). Assume Husband and Wife have a combined estate of $30 million ($15 million each). Husband predeceases Wife. Husband's will provides for a pecuniary non-marital bequest of Husband's remaining estate tax exemption to a bypass trust for Wife's benefit, with the remainder of the estate (the residual marital share)

Form 706 Deduction: Example 2

Increased portability available to survivor

Estate Assets	
$4,000,000	Estate
($1,000,000)	Fees
$3,000,000	Remaining Estate
As Reported on 706	
$4,000,000	Gross Estate
($1,000,000)	Fee Deduction
($0)	Marital Deduction
$3,000,000	Taxable Estate
$2,000,000	Portability Available
Funding	
$0	Pecuniary Marital
$3,000,000	Residue Bypass (Assumes No Change in Values)
Observations	
No Income Tax Deduction	
Increases Portability (Decreases Bypass)	

— Wesley L. Bowers

Form 1041 Deduction: Example 2

Less portability available to survivor

Estate Assets	
$4,000,000	Estate
($1,000,000)	Fees
$3,000,000	Remaining Estate
As Reported on 706	
$4,000,000	Gross Estate
($0)	Fee Deduction
($0)	Marital Deduction
$4,000,000	Taxable Estate
$1,000,000	Portability Available
Funding	
$0	Pecuniary Marital
$4,000,000	Residue Bypass (But Only $3 Million to Fund — Assumes No Change in Values)
Observations	
Estate Receives Current Income Tax Deduction	
Decreases Portability (Potentially Increases Bypass)	

— *Wesley L. Bowers*

passing outright to Wife. Under these facts, there's a pecuniary bequest of $5 million to the bypass trust, with the residue ($10 million as of date of death) passing to Wife.

As the expenses of the estate are borne by the residue (which passes to Wife), the estate transmission expenses analysis under the *Hubert* regulations comes into play. These estate transmission expenses reduce the marital deduction dollar for dollar on Form 706 (regardless of whether the deduction is claimed on Form 706 or Form 1041) because the expense is paid out of the marital/residue assets. Accordingly, it's often more beneficial to deduct expenses on Form 706 to offset the size of the gross estate in the amount of such deduction taken. Because the marital deduction is reduced by $1 million, a corresponding reduction of the estate in the amount of $1 million needs to occur on Form 706 to avoid estate taxes. (See "Form 706 Deduction: Example 3," this page.)

If, however, the deduction is taken on Form 1041, there will be a current income tax savings that's roughly equivalent to the amount of the estate tax owing, assuming the estate's income level has reached its highest bracket, and the deduction can be fully used. Although roughly equivalent, an estate's highest income tax rate is still often lower than the estate tax rate (not taking into account net investment income tax), so it's usually more beneficial to take the deduction on Form 706. (See "Form 1041 Deduction: Example 3," p. 35.)

The deduction is often best used on Form 706. If taken on Form 1041, an estate tax liability may occur as a result of the reduction of the marital deduction. The income tax savings is often less than the corresponding estate taxes that would be owed if deducted on Form 1041.

Example 4: Pecuniary bypass with residue marital (estate isn't large enough to fund marital bequest, but Form 706 is filed for portability). Assume the

Form 706 Deduction: Example 3

Amount of fees results in a marital reduction

Estate Assets	
$15,000,000	Estate
($1,000,000)	Fees
$14,000,000	Remaining Estate
As Reported on 706	
$15,000,000	Gross Estate
($1,000,000)	Fee Deduction
($9,000,000)	Marital Deduction (Reduced by $1 Million Under *Hubert* Regulations)
$5,000,000	Taxable Estate
$0	Portability Available
Funding	
$5,000,000	Pecuniary Bypass
$9,000,000	Residue Marital (Assumes No Change in Values)
Observations	
No Income Tax Deduction	

— *Wesley L. Bowers*

Form 1041 Deduction: Example 3

Estate tax liability may occur

Estate Assets	
$15,000,000	Estate
($1,000,000)	Fees
$14,000,000	Remaining Estate
As Reported on 706	
$15,000,000	Gross Estate
($0)	Fee Deduction
($9,000,000)	Marital Deduction (Reduced by $1 Million Under *Hubert* Regulations)
$6,000,000	Taxable Estate (Taxes Owed)
$0	Portability Available
Funding	
$5,000,000	Pecuniary Bypass
$9,000,000	Residue Marital (Reduced Further by Taxes) (Assumes No Change in Values)
Observations	
	Current Income Tax Deduction
	Estate Taxes May be Owed

— Wesley L. Bowers

same facts as Example 3, except that Husband and Wife have a combined estate of $6 million ($3 million each). Here, all assets of Husband's estate will pass to the bypass trust as part of the pecuniary bequest (and no additional assets remain to satisfy any portion of the residuary marital gift to Wife).

Under the *Hubert* regulations, estate transmission expenses must reduce the marital deduction if they're paid from the portion passing to the surviving spouse; however, there's no marital deduction as of date of death under this scenario, as all assets pass to the bypass trust. If professional fees of $1 million are deducted on Form 706, this will increase the amount of portability available for the survivor, as illustrated in "Form 706 Deduction: Example 4," this page.

If professional fees of $1 million are deducted instead on the estate's Form 1041, then the estate receives a current income tax deduction. Although the bypass trust is larger in theory under this approach (as in Example 2 above), assets of the estate have been depleted for the $1 million in estate expenses (assuming there's been no substantial growth of the residue). Moreover, even though there's a smaller amount for portability, the surviving spouse's estate, due to its size, may not be able to use much, if any, of the portability when the time comes. (See "Form 1041 Deduction: Example 4," p. 36.)

Deducting professional fees on Form 1041 often yields the best result, but you must carefully analyze whether the current income tax deduction is more valuable than the portability that you're otherwise giving up.

Example 5: All to surviving spouse outright. Assume Husband and Wife have a combined estate of $10 million ($5 million each). Husband predeceases Wife. Husband's will provides for a simple, outright distribution of his residuary estate to his Wife.

As all assets pass to Wife, the *Hubert* regulations are in play, and all estate transmission expenses that are

Form 706 Deduction: Example 4

Increased portability available to survivor

Estate Assets	
$3,000,000	Estate
($1,000,000)	Fees
$2,000,000	Remaining Estate
As Reported on 706	
$3,000,000	Gross Estate
($1,000,000)	Fee Deduction
($0)	Marital Deduction
$2,000,000	Taxable Estate
$3,000,000	Portability Available
Funding	
$2,000,000	Pecuniary Bypass (Assumes No Change in Values)
$0	Residue Marital
Observations	
	No Income Tax Deduction
	Increases Portability (Decreases Bypass)

— Wesley L. Bowers

Form 1041 Deduction: Example 4

Less portability available to survivor

Estate Assets	
$3,000,000	Estate
($1,000,000)	Fees
$2,000,000	Remaining Estate

As Reported on 706	
$3,000,000	Gross Estate
($0)	Fee Deduction
($0)	Marital Deduction
$3,000,000	Taxable Estate
$2,000,000	Portability Available

Funding	
$3,000,000	Pecuniary Bypass (But Only $2 Million to Fund — Assumes No Change in Values)
$0	Residue Marital

Observations

Estate Receives Current Income Tax Deduction
Decreases Portability (Potentially Increases Bypass)

— *Wesley L. Bowers*

deducted on either Form 706 or 1041 must also reduce the marital deduction. If professional fees of $1 million are deducted on Form 706 (or aren't deducted at all), this maximizes the amount of portability available for the surviving spouse, as illustrated in "Form 706 Deduction: Example 5," this page.

If professional fees of $1 million are deducted instead on Form 1041, then the estate receives a current income tax deduction. However, deducting these transmission expenses must offset the marital deduction, which decreases the amount of portability available to the surviving spouse because there's no corresponding deduction of the fees on Form 706 (this may or may not be a concern, depending on the size of the surviving spouse's projected taxable estate). (See "Form 1041 Deduction: Example 5," p. 37.)

Deducting professional expenses on Form 1041 typically provides the most benefit, but you must carefully analyze whether the current income tax deduction is more valuable than the portability that you're otherwise giving up.

Results May Vary

As you can see, there's no one size fits all to the analysis on whether to deduct professional fees on Form 706 or Form 1041, and the results can vary significantly depending on the unique circumstances involved with the particular set of facts at hand. However, take care to analyze your particular case against various competing factors, which can include (among others): funding formula involved, size of the estate, projected future appreciation, anticipated estate tax situation of the surviving spouse, amount of estimated estate income, tax rates involved and impact of future legislation. Also, don't forget to take state income and inheritance tax calculations into consideration when running the analysis. Moreover, when deciding whether to deduct on Form 1041, remember that some deductions are subject

Form 706 Deduction: Example 5

Maximizes amount of portability available to surviving spouse

Estate Assets	
$5,000,000	Estate
($1,000,000)	Fees
$4,000,000	Remaining Estate

As Reported on 706	
$5,000,000	Gross Estate
($1,000,000)	Fee Deduction
($4,000,000)	Marital Deduction
$0	Taxable Estate
$5,000,000	Portability Available

Funding	
$4,000,000	Remaining Residue to Spouse

Observations

No Income Tax Deduction
Increases Portability

— *Wesley L. Bowers*

Form 1041 Deduction: Example 5

Current income tax deduction more valuable, but less portability

Estate Assets	
$5,000,000	Estate
($1,000,000)	Fees
$4,000,000	Remaining Estate

As Reported on 706	
$5,000,000	Gross Estate
($0)	Fee Deduction
($4,000,000)	Marital Deduction
$1,000,000	Taxable Estate
$4,000,000	Portability Available

Funding	
$4,000,000	Remaining Residue to Spouse

Observations
Estate Receives Current Income Tax Deduction
Decreases Portability

— Wesley L. Bowers

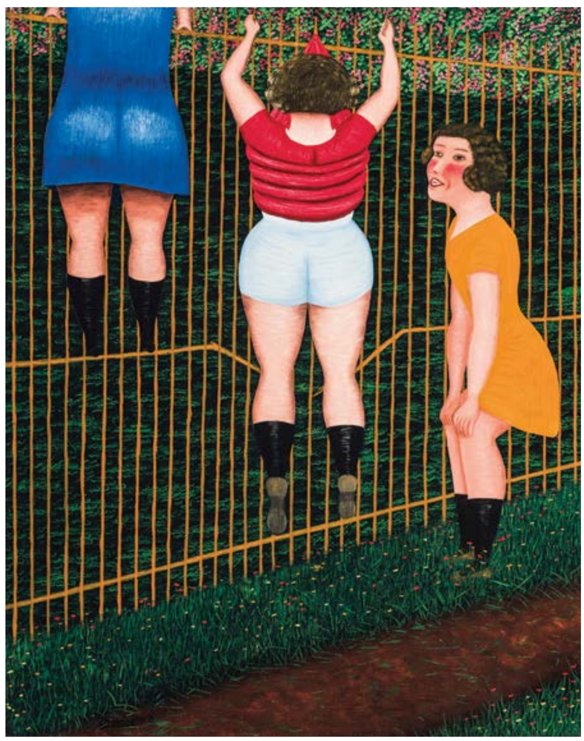
to the 2 percent floor, where only amounts greater than 2 percent of adjusted gross income can be deducted.[8]

Another important item to note is that while you can't "double deduct" the amount of professional fees, this rule doesn't preclude you from splitting the deduction between Form 706 and Form 1041. For example, a portion of the expenses can be deducted on Form 1041 to the extent needed to offset anticipated estate income, while taking the remaining deduction on Form 706 to increase the amount of portability.

Finally, any professional expenses deducted on Form 1041 that aren't fully used to offset income during the administration of the estate can generally be carried forward from the estate to the ultimate beneficiary.[9] This, like the many other factors discussed, could have an impact on your analysis.

Endnotes

1. Internal Revenue Code Section 642(g).
2. The prohibition against double deductions doesn't apply to deductions in respect of a decedent under IRC Section 691(b). Examples of such expenses are interest and property taxes accrued prior to a decedent's death, which can be deducted on both Form 706 and Form 1041.
3. Named in response to the discussion of the prior regulations by the U.S. Supreme Court in *Hubert v. Commissioner*, 520 U.S. 93 (1997). These regulations can generally be found at Treasury Regulations Sections 20.2013-4(b)(3); 20.2055-3; and 20.2056(b)-4(d).
4. Treas. Regs. Sections 20.2055-3(b)(1)(i) and 20.2056(b)-4(d)(1)(i).
5. Treas. Regs. Sections 20.2055-3(b)(1)(ii) and 20.2056(b)-4(d)(1)(ii).
6. Treas. Regs. Sections 20.2055-3(b)(4) and Section 20.2056(b)-4(d)(1)(iii)(4).
7. Treas. Regs. Sections 20.2055-3(b)(3) and 20.2056(b)-4(d)(3).
8. *See* Treas. Regs. Section 1.167-4, which is in response to *Knight v. Comm'r*, 552 U.S. 181 (2008), issued by the U.S. Supreme Court.
9. *See* Treas. Regs. Section 1.642(h)-2.

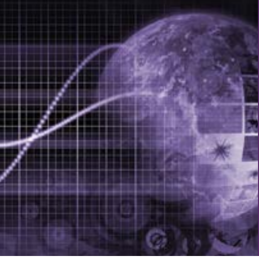


SPOT LIGHT

Hang On

"La grille rompue," by Camille Bombois sold for $45,975 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017. Bombois' earlier works attracted few buyers; however, he was eventually "discovered" by an art dealer in 1924 who helped him gain exposure by exhibiting his paintings at various galleries.

SHARE this article Click for more ESTATE PLANNING



By Matthew Wesley, Michael Liersch & Scott Cooper

A Strategic Approach to Estate Design

Create a structure that matches a family's culture

Some families do well in generational transitions, but many fail—some miserably. Those that thrive are rare, but not as rare as some think. These families tend to be strong, resilient and deliberate. But most importantly, they're paying attention to the real threats to wealth.

These families understand that successfully navigating wealth is a bit like flying a jetliner—two, well-matched wings are required. One strong and one weak wing won't do. Failure of either wing is catastrophic. In many families that flounder, the "planning wing" has received disproportionate attention—trusts are established, advisors are in place, tax strategies are adopted and investment approaches are calibrated. The planning is superb. But, these complex structures comprise only one wing of the plane, and the other is equally important—the wing of family "culture."

Creating estate-planning structures that match the family culture is critical. Identifying misalignment between culture and structure can help families—in collaboration with their professional team—create an intentional cultural shift (over time) or design a plan that's more likely to succeed given the existing family culture. This practice can help mitigate everything from family legal battles to negative relationship dynamics by promoting positive family interactions and outcomes.

Culture

Culture is the unseen driver of family behavior. Every family has invisible "software" that encompasses its beliefs, perspectives, attitudes and actions. Families that successfully curate their cultural software take charge of writing their own "operating systems."

Lack of attention to nurturing family culture is the principal reason most plans fail. Three primary conditions underlie this inattention:

1. **Fear.** Concern about confronting challenging family dynamics or historical behaviors can leave culture unaddressed. Family members may believe that discussing challenging issues could worsen financial outcomes and relationships. While that's certainly possible, if discussions are navigated thoughtfully, a family can rewrite its cultural software.

2. **Complexity.** Families are complex. Navigating that complexity requires frameworks (such as those outlined in this article). It also requires dialogue and the collective development of beliefs, perspectives and principles that guide the actions of the family.

3. **Inconsistency.** To establish a productive family culture, family leaders help uncover ways to hold individuals and the collective accountable. Family meetings and policies help to create a cadence of consistency that can align the family.

The Pathways

Advisors who systematically plan for transition as a culturally embedded process serve their clients more effectively. This planning allows family leaders and

L to R: **Matthew Wesley** is a director in Merrill Lynch's Center for Family Wealth Dynamics and Governance in Seattle, **Michael Liersch** is Merrill Lynch's head of Behavioral Finance and Goals-Based Consulting in New York City and **Scott Cooper** is a managing director in Merrill Lynch's Strategic Wealth Advisory Group in New York City



their advisors to play a proactive long game so they're not just tactically reducing estate taxes (which aren't the greatest threat to wealth), but strategically matching the structures created to the individuals who are inheriting the wealth. The goal of planning shifts from merely saving taxes to matching the capacities and capabilities of beneficiaries (failure to do so can cause wealth to disappear).

To help with this matching process, we've identified three core overarching strategies designed to help ensure that wealth, once accumulated, is more likely to achieve its strategic purpose over generational transitions. We call these strategies "Pathways." Each Pathway requires different levels of preparation and different levels of teamwork on the part of the family members. Any Pathway is a valid choice—the question isn't which is "better" but which best fits a particular client family.

Pathway 1: Division

In this first Pathway, each heir receives some fixed amount, and the balance goes towards taxes or to charity. This Pathway usually results in the disappearance of the wealth within a generation or two. Typically, such plans arise from concerns about enabling entitlement among children or not wanting to saddle children with the complexities of trusts and entity management.

Metaphor: In explaining these strategies, we use the analogy of the goose that lays the golden eggs. In division, the eggs are given to the children, and the goose (or bulk of accumulated capital) goes to charity or the government.

Structures: Division estate plans are basic; they don't include generation-skipping trusts, entity planning or other complex structures designed to last for extended periods of time. At most, these plans educate grandchildren and/or give them a jumpstart on their financial life, but terminate quickly after that.

Skillsets required for success: For such plans to be successful, beneficiaries must have financial literacy (that is, how to effectively earn, save, invest and spend their money).

When things go bad: Wealth erodes rapidly from such things as overspending, failure to hold productive employment and psychological issues such as mental illness, addiction or the inability to maintain stable social connections.

Pathway 2: Preservation

Preservation is the predominant approach of many wealthy families and advisors. Here, the patriarch and matriarch adopt a complex structural matrix of entities designed to reduce taxes and exercise control after death. The anthropologist George E. Marcus, who studied wealth in families, calls these structures "Surrogates" in that they stand in proxy for the control of the wealth creator.[1] At death, the Surrogate employs a host of advisors who manage the entities and the assets within them. This becomes what Marcus calls the "Formation." He noted that, in wealthy families, children don't inherit wealth—they inherit Formations defined as complexes of structures that hold wealth and advisors who manage it. Active professional capital management and passive beneficiaries with strictly limited responsibilities are the hallmarks of this planning.

Adequate preparation allows Preservation strategies to maintain assets for a generation or two.

Adequate preparation allows Preservation strategies to maintain assets for a generation or two. Inadequate preparation often tips over into failures to launch, attitudes of entitlement and even lawsuits. Ultimately the numerical growth of the family will deplete the wealth.

Metaphor: Here our erstwhile goose is entrusted to "third-party" farmers charged with keeping the goose healthy and productive. Eggs are distributed to the beneficiaries who use them as they see fit. Eventually, the law of large numbers and the limits of productivity exhaust the goose, and she dies.

Structures: The structures in a Preservation strategy usually involve complicated interlocking trust structures and entities. Professionals with fiduciary obligations to both present and future beneficiaries manage these structures and entities.

Skillsets required for success: Family members must not only develop financial competency, but also develop a sophisticated wealth competency. They learn to understand the structures and work effectively with the advisors who support those structures. These tasks are often supported by family meetings, a common vision and commitment to core family principles.

Over and above the other skills, families that succeed focus on the culture of the family and on teamwork.

When things go bad: This Pathway is arguably the most difficult to successfully sustain: Legal entitlement often slips into indolence. Most often, the family begins to demand more than the structures can produce.

Pathway 3: Growth

The family actively manages the complex structures that were passively employed under the Preservation strategy. The structures either work or fail based on the ability of the family to productively collaborate. Professional advisors play a supporting role. Often, these families inherit direct ownership in operating companies that require them to become excellent owners, board members and business managers. Technical and cultural advisors support the work of the family.

Metaphor: In this scenario, the family develops the skills to be goose farmers. They're careful not to demand too many eggs; the optimal care and comfort of the goose is what's most important.

Structures: Sustainable structures for Growth require deliberation and family decision making. Often, capital is distributed among actively managed assets, such as real estate holdings and operating companies, as well as more traditional diversified portfolios of passive asset classes. In this Pathway, structures such as family offices, operating companies, trust companies and family foundations become part of the planning.

Skillsets required for success: Over and above the other skills, families that succeed focus on the culture of the family and on teamwork. Capital is invested in the personal development of individuals and the collective evolution of the family. Most families must hone business competencies as owners, managers, governors and directors. These families are typically characterized by regular whole family gatherings and eventually develop moderating governance structures such as family assemblies, constitutions, policies and councils. The entire family becomes a learning community with an intentional commitment to its own evolution through mentoring and experiential learning. Leaders arise as "torchbearers" in each generation out of a deep commitment to family cohesion.

When things go bad: These plans tend to fall apart because of failures of collaboration; failures of family commitment; and insufficient or hard to exercise exit and re-entry for family members who have different interests.[2]

Trade-offs

Is one Pathway "better" than another? No. All of the Pathways involve trade-offs. Pathway choice should be non-judgmental—what's most important is that both wings are in balance to take flight and achieve the family's desired outcomes. What's essential is that successful plans account for the culture and capacity of the family to bring the chosen Pathway alive in ways that enhance the lives of beneficiaries.

Endnotes

1. George E. Marcus and Peter Dobkin Hall, *Lives in Trust: The Fortunes Of Dynastic Families In Late Twentieth-century America*, Westview Press (March 30, 1992).
2. Once the planning and culture "wings" are aligned and the family is launched, some families move to a different stage not discussed here. A rare few move into an "Expansion" Pathway where—in our goose analogy—the eggs (and the goose) are sold to buy more geese.

AiP

THE INTERNATIONAL ASSOCIATION OF
ADVISORS IN PHILANTHROPY

2017 Conference on Philanthropy

Register Now!

April 19—21
Westin South Plaza, Costa Mesa, California

The International Association of Advisors in Philanthropy (AiP) proudly presents its 2017 Conference on Philanthropy.

The Conference on Philanthropy will provide you with the tools you need to empower your clients/donors in supporting their deepest values with their philanthropic resources. Our conference features a schedule jam-packed with valuable charitable planning content, plenty of time to make connections with like minded professionals, and opportunities to expand your collaborative possibilities with those who share your passion for the life-changing power of philanthropy.

Taking place April 19—21 at the Westin South Coast Plaza in Costa Mesa, CA, this conference brings together a diverse international membership including financial advisors, attorneys, insurance professionals, accountants, and non-profit executives.

Register now!
Visit www.advisorsinphilanthropy.org for details and registration.

Questions? Contact the AiP office at 312.252.2501 or admin@advisorsinphilathropy.org

The International Association of Advisors in Philanthropy | 216 W. Jackson Blvd., Suite 625
Chicago, IL 60606 | 312.252.2501 | advisorsinphilanthropy.org | admin@advisorsinphilanthropy.org

COMMITTEE REPORT:
INSURANCE

By **Melvin A. Warshaw**

Life Insurance in Uncertain Times

The ILIT (or hybrid DAPT) may provide a hedge

Once again, the country faces the prospect of Washington fiddling with the Tax Code, fanning uncertainty over the future of our overall tax system. Deja vu, estate tax "reform" is in the air. How should advisors and clients handle insurance planning in the next decade, especially given that we've been down this road before? The experience learned might serve as a guide for the future.

Congress and POTUS #45

Little has been heard from POTUS #45 (Donald J. Trump) about tax reform since his inauguration a few months ago. Based on the Republican-led Congress' blueprint, we know that both POTUS #45 and the GOP agree that Republicans would like to eliminate the estate tax (again). In truth, the Republican blueprint prepared in the House has more flesh on the bone than the rather scanty proposals POTUS #45 suggested during the campaign.

It seems like the process will be much like that in 2001. Today, Republicans hold a narrow 52 to 48 majority in the Senate, making it virtually impossible to enact tax legislation the traditional way because it will run up against the filibuster rules that require 60 votes to shut off debate and proceed to passage. This means that POTUS #45 and Republicans in Congress will be forced to rely on the budget reconciliation process, which only requires a 51 vote simple majority in the Senate. However, budget reconciliation will be subject to the Byrd rule and will be required to sunset after 10 years, the same as POTUS #43's tax reform package adopted in 2001.

Melvin A. Warshaw is general counsel at Financial Architects Partners, LLC in Boston

Adoption of some type of estate tax phase-out over the next 10 years, coupled with a capital gains tax on appreciated assets in excess of $10 million for a married couple, seems possible.

Uncertainties

While sages tell us that death and taxes are certain, advisors know that their clients have never faced more uncertainty over their estate planning. Mortality is predictable when applying large numbers but becomes virtually impossible to predict on an individual basis. No advisor knows whether his client will die while there's no estate tax in place or while there's an estate tax. And, that's the federal law. What about the state estate and inheritance taxes today imposed in almost 20 states? Certainly those state governments need the tax revenue raised by these taxes to balance their budgets. Layered on top of these uncertainties is the apparent desire of POTUS #45 to replace the estate tax with a capital gains tax at or after death to partially offset the lost tax revenue. However, the details from POTUS #45 on this capital gains tax at or after death are sparse.

All advisors are seeking flexible solutions for their clients. We have to be prepared that, as the tax laws gyrate from a currently in-force estate tax system to repeal and then back to reinstatement, our clients are protected in a variety of scenarios.

A few advisors have already proposed different types of flexible trust structures to accommodate this brave new world. Some of these trust structures rely on existing freeze strategies that retain the emphasis on a transfer of future appreciation but restructure the terms of the recipient trust. Others rely on making dollar-for-dollar non-leveraged completed gifts to a specific type of asset protection trust. While these trust strategies are clearly viable, is there anything else available in the estate planner's quiver to deal with the impending uncertainty?

Integrating Certainty

An irrevocable life insurance trust (ILIT) provides a hedge against the uncertainty of future tax law changes, investment underperformance and the possibility of a premature death. An ILIT provides a predictable result if the estate tax is repealed under the Trump administration and then reenacted by a subsequent Democratic administration. Life insurance held in trust provides a near certain outcome of a leveraged liquid death benefit (paid in cash) that's flexible so that it can apply either to a Canadian-style capital gains tax at death, a carryover basis at death and deferred tax until heirs sell inherited property or a hybrid system with a $10 million exemption.

ILITs also provide a low cost solution to the likely continuation of the current gift tax system as funding relies on split-dollar plans, loans that are sanctioned in final regulations or *Crummey* withdrawal powers. Using annual exclusion gifts to fund the trust-owned life insurance program preserves a taxpayer's lifetime gift tax exemption to a later date, so taxable gifts and gift tax needn't be incurred to implement the life insurance funding.

If decoupled states extend their state estate taxes following federal estate tax repeal or other states continue current inheritance tax systems or enact new types of taxes at death, life insurance death benefits can cover all of these existing or new tax obligations. Of course, as in the past, life insurance can provide a certain fixed benefit regardless of whether the insured client lives one or 30 years after purchase and safeguards against sudden deterioration in health as the client ages.

Hybrid DAPT

The completed gift life insurance hybrid domestic asset protection trust (hybrid DAPT) is the brainchild of my friend Steve J. Oshins of the Law Offices of Oshins & Associates, LLC in Las Vegas. Steve writes of advisors' current need to move assets away from a settlor's estate, but with the snap of their fingers be able to cause estate inclusion over those assets based on the possibility of a change in the estate tax rules and then again with the snap of their fingers be able to reverse that estate inclusion decision.[1]

According to Steve, the hybrid DAPT acts like a traditional third-party ILIT until the trust protector adds the settlor as a permissible (discretionary) beneficiary. A protector would only add the settlor as a beneficiary if the settlor needs to access cash value. In these circumstances, saving federal estate taxes is likely less important than managing the settlor's cash needs during his lifetime.

Before undertaking a hybrid DAPT, you need to understand the potential risks compared with a traditional incomplete gift DAPT strategy and consult with an expert.

If the settlor has significant assets and expects a liquidity issue at death, he could always sell illiquid assets to either the traditional ILIT or hybrid DAPT, both of which would be structured as grantor trusts as to the settlor. This sale would enable the settlor's estate to have direct access to the cash (death benefit) while removing illiquid and presumably low basis assets from the settlor's estate. Steve indicates that this strategy is preferable to adding the settlor as a beneficiary.

Before undertaking a hybrid DAPT, you need to understand the potential risks compared with a traditional incomplete gift DAPT strategy and consult with an expert. Steve notes that the Internal Revenue Service approved the hybrid DAPT strategy in Private Letter Ruling 200944002 (July 15, 2009), in which a resident of a DAPT jurisdiction established the DAPT using the laws of that jurisdiction. As for the vast majority of

Americans who aren't residents of a DAPT jurisdiction, while most commentators believe the strategy works, Steve points out that the courts haven't determined whether the DAPT assets are available to the settlor's creditors because it's still unclear which state law will apply for creditor purposes.

Life Insurance as an Asset Class

In a world of tax uncertainty, how does life insurance stack up as an asset class?

Current tax law offers the following tax attributes to life insurance:

- Income tax-free compounding for life.
- Potential elimination from income tax on the lifetime tax-free accumulation inside a policy if owned until death. Only Roth individual retirement accounts provide a similar lifetime tax-free build-up of investment and elimination of income tax at death, but unlike life insurance, there are annual limits on funding Roth IRAs that make them unavailable to wealthy individuals.
- Earnings on the policy may be borrowed income tax-free in a non-modified endowment contract (MEC) policy.
- At death, the cash value account and amount at risk disappear, and the death benefit is generally received income tax-free regardless of owner. This means an ILIT in effect generally receives at the death of the insured the equivalent of a basis step-up in the policy from premiums paid (and cash value) to the death benefit amount under Internal Revenue Code Section 101. There's no income tax on the amount "at risk" to the carrier during the life of the insured. Even if Congress eliminates basis step-up, this would require repeal of the general basis step-up at death provision under IRC Section 1014. Such a major change in the tax basis rules presumably would have no effect on the special rules elsewhere in the Tax Code under Section 101, which affords life insurance death benefit unique income tax treatment at the death of the insured.
- Unlike traditional taxable investments as to which taxable income is incurred when profits are taken on sale of a position, a change of investment manager in a variable life insurance product or switch to a new insurance product type under an IRC Section 1035 exchange won't trigger taxable gain inside the policy.
- On surrender of a policy, any gain will be ordinary income, not capital gains. No capital loss is allowed on surrender of a policy when premiums paid exceed the cash value. On settlement of a policy (sale), there are potentially more favorable tax results to the seller, a discussion of which is beyond the scope of this article.

Current tax law offers the following additional tax attributes to an ILIT:

- It's easy to avoid estate/generation-skipping transfer (GST) tax through ILIT or hybrid DAPT ownership of the policy. The advisor must avoid "incidents of ownership" held by the insured in the ILIT or hybrid DAPT, which means the insured can't be the trustee of the ILIT or the hybrid DAPT.
- Gift (and GST) tax can be minimized and leveraged on funding of an ILIT or the hybrid DAPT by relying on either of the fully sanctioned split-dollar regimes (economic benefit or applicable federal rate (AFR) loan interest) to measure the annual gift of life insurance coverage.

Hedge Tax Uncertainty

Our company has internally prepared some carrier models that support my conclusions about how to view and consider different types of life insurance in an era of uncertainty. Consider this example. Assume the client:

- is age 60 and in good to excellent health;
- has a net worth in excess of $30 million with illiquid concentrated investments that have high growth potential;
- is focused on the next 10 years;
- is primarily focused on the uncertainty of future law and how it could impact his estate and family;
- is mindful of avoiding large taxable gifts due to uncertainty about the future of the gift tax and possible reinstatement of the estate tax;
- wants flexibility in 10 years to dial up or down the need for liquidity at death;
- likes the leverage of life insurance. The client can spend $1 over the next 10 years and net anywhere from $3 to $9 of death benefit coverage for his heirs over the same time frame, and then decide what to do

depending on intervening law and investment results; and

- is interested in purchasing single life coverage of $10 million.

Limit annual premium outlay. The client may decide his primary objective is to limit annual premium outlay over the next 10 years. The client doesn't care about receiving anything back in 10 years and is looking for the cheapest way to cover a potential liability and provide direct or indirect liquidity for his family.

Premiums are kept to a bare minimum and try to mimic term coverage but, nonetheless, it's a purchase of permanent life insurance. No further medical exam would be required to keep the policy in effect after the 10-year period while locking in future premium costs. (On a future term conversion, the medical underwriting is locked in; however, the actual future permanent product available and its cost isn't locked in when the term policy is originally sold.) For this client, the choice comes down to a consideration of index universal life (IUL) or no-lapse guarantee universal life (NLGUL) step funding.

NLGUL step funding offers the lowest permanent coverage cost (under $95,000 annually for 10 years) but has no cash value build-up over the 10-year period. If the client surrenders the policy in 10 years, he'll receive nothing back. Moreover, after the 10-year period, premiums would have to increase to $208,000 for Years 11 to 20 and $303,000 for Years 21 to 30. Absent any cash value, the client has limited ability to roll over to a new policy without a new physical in 10 years. The NLGUL step funding is a fairly inflexible lifetime commitment to an ever-increasing premium outlay beyond the initial 10-year period. If unwilling to pay higher premiums after the initial 10-year period, the only alternative then available would be to reduce the policy death benefit. The NLGUL step funding shifts the entire investment risk to the carrier, and the client is relying on the long-term claims-paying capacity of the selected carrier, which warrants some diversification among top-rated carriers.

IUL offers more cash value build-up than NLGUL step funding, but the cash value accumulation is still less than the aggregate premiums paid. IUL is more expensive than NLGUL step funding at $149,000 annually. However, this cost for IUL coverage is projected to remain the same beyond the 10-year period. At the end of the 10-year period, assuming a 5 percent annual pre-tax return based on the equity index selected, there would be $690,000 in policy cash value. The client could recover about 46 percent of his premium outlay at the end of 10 years. Alternatively, the client could continue to pay $149,000 annually to extend the coverage beyond the 10 years. The client bears the investment risk on that portion of the premium invested in equity indices. The carrier typically provides a minimum investment return (for example, 1 percent, known as a "floor") and a maximum investment return (for example, 11 percent, known as a "cap"). The bottom of the floor is guaranteed by the carrier, but the carrier could theoretically increase the top of the floor. The cap usually has a guaranteed minimum of about 3 percent. Clearly, the client bears some investment risk with an IUL policy. The carrier has the ability to change the floor and cap during the life of the insured. The balance of the premium is invested in the carrier's general account consisting of primarily 10-year Treasuries over which the carrier retains complete investment responsibility.

Minimize net out-of-pocket outlay. The client may decide that the best approach is to minimize his out-of-pocket cost for the 10 years of coverage, enabling him to recover as much as possible in 10 years. The client is willing to spend something more than the minimum premiums required to keep coverage in force for 10 years while retaining a permanent policy. Here, the client is concerned with maximizing options available in 10 years.

A whole life (WL) policy is expensive and would provide significant cash value build-up in 10 years. The major disadvantage of a WL policy is that there's often limited flexibility to change the premium outflow, other than to dramatically stop all further premium payments and accept a reduced face amount. If a mature WL policy has been in force for many years and has accumulated significant cash value and the carrier is paying a meaningful current dividend, it may be possible to use the combination of both cash value and future dividends to pay future premiums. The carrier has the ability to change (for example, decrease in recent years) the dividend crediting rate on the policy, which could force the owner to either pay increased premiums or decrease coverage. Nevertheless, through its forced

savings approach, the client would be able to recover in excess of 80 percent of premium outlay in 10 years, so the net cost for the coverage would be about $490,000. At the end of 10 years, the client would be committed to paying $246,000 annually for life to continue coverage, however, depending on the carrier's projected future dividend rate, the death benefit could be expected to grow well beyond $10 million assuming normal life expectancy.

In a traditional "all pay" UL policy (same premium amount annually), the annual premiums would be $171,000 annually; however, the cash value in 10 years using a 4.55 percent current crediting rate would be $966,000. The client can recover roughly 55 percent of the premium outlay at the end of 10 years. The client bears no investment risk, as the carrier invests the premiums entirely in its general account. In 10 years, if coverage was still needed, the client could continue to pay the $171,000 regardless of his then current health. If the client were then healthy, he could take a new physical and determine whether to roll over the $966,000 cash value to a new, possibly more efficient, policy.

There's an enormous risk in delaying the purchase of life insurance as we muddle through another period of uncertainty over the tax laws.

Maximize flexibility. Another more conservative but highly flexible approach would be to fund a UL short pay policy. Here, the client pays $655,000 annually for five years. Thereafter, the policy should be fully paid up (subject to future carrier crediting rates), and no further premiums are required during life. In 10 years, if the client were to decide to surrender the policy, he would receive back over 80 percent of the premium outlay, reducing his overall costs to $640,000 for 10 years of coverage. The policy is structured as a non-MEC, so the client could borrow tax-free against the policy if he needed cash and was willing to decrease the net death benefit. If the client believed that the estate tax was likely to return or that investment performance had underperformed, the paid-up policy could remain in place. If healthy and able to take a physical, the client could roll over the $2.66 million of cash value into a new, more efficient policy, perhaps with a higher death benefit or some premium holidays. If the estate tax is repealed and the client believes that such tax will never be reinstated by a future Democratic administration, the client could allow the policy to lapse. The UL short pay policy provides the best and widest options, but the client is paying more premiums earlier to enjoy these options.

Multigenerational family business or leveraged real estate family. For these families, the goal of life insurance is to provide the most efficient death benefit coverage, and NLGUL (level pay) may be the best selection. These families don't need or benefit from cash value accumulation inside a policy. They want the secondary guarantee of the carrier, which locks in the premium amount for life. The carrier bears all investment risk. A level premium payment allows the family business to budget its long-term cash flow. The business can advance premiums under an employer or entity split-dollar plan or loan. Selection of a diversified portfolio of NLGUL (level pay) policies each issued by a top-rated carrier protects against the long-term claims-paying capacity of any one carrier.

Real estate developers and owners. Today's tax rules, which permit a step-up in basis at death, incentivize real estate developers and other significant investors to personally own such property or the limited liability company (LLC) or partnership interests associated with such property. The underlying property may have a negative basis (that is, the debt against the property exceeds the income tax basis in the property). Under current law, after death, the deceased developer's estate or investor's heirs take the real estate with a date-of-death fair market value basis, thereby eliminating depreciation recapture and realization of gain on the liabilities in excess of basis.

Conversely, under a new capital gains tax at death, Canadian-style system for the wealthy, heirs inheriting negative basis or highly leveraged assets will face an immediate income tax with the debt treated as an

amount realized, including any negative basis. Advisors will counsel on different ways for developers or owners to build basis at death, including allocating LLC or limited partnership (LP) debt to older members or partners or requiring them to personally guarantee entity debt.

Clearly, it makes sense for these real estate families to consider some type of NLGUL policy. Like their fellow family business owners, they should be able to take advantage of the split-dollar rules. Care must be taken to make sure the real estate owner doesn't have an equity ownership interest in the LLC or LP entity that advances the premiums on behalf of the donee ILIT or hybrid DAPT named as beneficiary of the net death benefit. To avoid incidents of ownership concerns, the insured-settlor must have no decision-making authority within the LLC or LP that advances premiums for the life insurance policy.

If there's essentially an estate tax repeal/carryover basis at death tax system for wealthy decedents, leveraged real estate owners would avoid a liquidity shortfall at death, as any capital gains tax would be deferred until a subsequent sale. To avoid a subsequent sale generating a tax bill to the heirs, those inheriting low basis, highly leveraged real estate would be encouraged to swap existing property for more highly leveraged real estate with escalating rent in an IRC Section 1031 exchange to generate additional cash flow.

Even here, state estate taxes and lender calls may warrant a source of instant liquidity at death, such as life insurance, to alleviate the transition from older generation to next generation.

Cost of Delay

Strategies such as grantor retained annuity trusts and sales to defective trusts for a promissory note take time to shift appreciation out of the donor's estate. Some of these transactions will be implemented and will underperform their appreciation hurdle rates, resulting in failure. Intra-family AFR loans to grantor trusts make sense during these unprecedented low interest rate times, but what happens when AFRs rise towards historic norms, along with bond and Treasury yields, or the grantor trust rules change?

There's an enormous risk in delaying the purchase of life insurance as we muddle through another period of uncertainty over the tax laws. Declining health in either or both spouses during the next 10 years may make the couple uninsurable or heavily rated in the future, resulting in more expensive premiums. Future declination of coverage due to an intervening change in health status is an advisor's worst nightmare. Mere aging of a client with no change in health over the next 10 years will still increase the cost of insurance in the future, reducing the amount of coverage available in 10 years and leaving a gap between liquidity need and coverage amount.

Lock In Coverage

Very wealthy families, real estate developers or investors who know they'll incur some type of tax liability at or after death because they'll hold appreciated assets will want to lock in lifetime life insurance coverage while shifting all investment risk to the carrier, through the purchase of an NLGUL policy. In recent years, carriers have come and gone from the NLGUL market while others have just entered the NLGUL market. What if the NLGUL market disappears in 10 years due to mandates from state regulators for carriers to increase their capital reserves on these NLGUL policies, and your client asks why you didn't advise locking up a minimum amount of future liquidity while it was available and cost efficient and he was healthy?

For some very wealthy families, in which the patriarch is either fully insured or currently uninsurable, the patriarch or his family office may play the role of a family bank and lend premiums to an ILIT to fund premiums providing coverage on the life of children or grandchildren. Children or grandchildren with a 60 to 90-year life expectancy can expect the estate tax to return at some point in their lives. The out-of-pocket cost to have their families purchase life insurance today is far less expensive and locks in insurability, rather than wait until the estate tax is reinstated and run the risk that the child or grandchild may then be uninsurable.

Younger clients on the cusp of realizing growth in their net worth need to focus on how to lock in coverage for the next 10 years. Do they want to minimize premium outlay and minimize their net outlay with some alternatives available in 10 years, or do they want to maximize flexibility in 10 years? All of these factors will be relevant in selecting the most cost-effective product and funding it over the next 10 years.

Endnote

1. Steven J. Oshins, *LISI Newsletter* #2511 (Feb. 1, 2017).

By **Charles L. Ratner & Lawrence Brody**

Life Insurance Policy Selection and Design

What works best in various financial and estate-planning scenarios?

Clients routinely ask their estate planners basic questions about life insurance. Sometimes, the questions lend themselves to a quantifiable answer, such as the amount of insurance needed to replace a deceased's earnings or preserve an estate from estate tax. But, often the questions aren't about how much. They're about what type of policy is appropriate for the need, how it should be designed and how it should be funded.

To be sure, there are no hard and fast rules that govern the selection and design of a policy in a given planning application. However, planners can develop a fairly intuitive approach to help the client determine whether the prescription is best filled with term insurance or some form of permanent policy, and if the latter, which type of policy offers the characteristics that are best aligned with the client's objectives and circumstances.

We'll discuss types of term insurance policies first and when term can be the appropriate choice. Then, we'll look at permanent policies, which we will refer to as cash value policies, describing the various types that are available in the marketplace today and noting when each might be appropriate for a given application. Finally, we'll consider several common scenarios in which planners can apply the principles and guidelines discussed.

Term Insurance

With an annual renewable term (ART) policy, the death benefit stays level but the premium increases every year. As long as the insured pays the premium, the policy remains in force. The policy illustration (or the policy itself) shows a "current premium" and a "maximum guaranteed premium." The current premium is what the carrier is now charging and expects to charge for the coverage. The maximum guaranteed premium is what the carrier is contractually able to charge for the coverage. The main reason to understand ART, and the difference between current and guaranteed charges, is because it's essentially the mortality component of many of the cash value policy types we'll discuss.

Level premium term takes a different approach. Premiums are indeed level for a stated number of years, such as 10, 15, 20 or 30. With this product, there's no distinction between the current and guaranteed premiums. The stated premium is in fact the guaranteed premium that the insured will pay for the stated duration. At the end of the guarantee period, the insured may have some options for continuing the coverage. The insured might be able to "re-enter" or medically re-qualify for another period of equal duration at guaranteed rates or just continue the coverage at the carrier's prevailing ART rates. In either scenario, the coverage isn't lost, but will be much more expensive because it will essentially mirror the carrier's ART rates at the attained age.

Either type of term policy can be convertible, which means that the insured can exchange the term policy for a cash value policy without evidence of insurability, so long as the exchange is done within the conversion period, which may be stated as prior to a certain age or as a certain number of policy years. In some policies, the conversion period may be a lot shorter than one would expect from the length of the guarantee period. The prospective purchaser should be comfortable that the conversion period is long enough to be meaningful, that is, it won't expire well before the individual would likely be interested in converting. Also, he'll want to find out

Charles L. Ratner, left, is senior director, Washington National Tax, at RSM US LLP in Cleveland, and **Lawrence Brody** is a partner at Bryan Cave LLP in St. Louis

whether the policy is convertible into all of the carrier's cash value products that it offers at time of conversion, just some products or even just one product.

Cash Value Policies

We'll describe several types of cash value policies, including whole life (WL), WL/term blend, current assumption universal life (CAUL), guaranteed (no-lapse) universal life (GUL), equity indexed universal life (EIUL) and variable universal life (VUL).

Planners can add great value to their clients by helping them identify the characteristics of a policy or policies that they feel would be appropriate for them over the long term. In practice, meaning in real cases in which an agent is presenting products to a client, we suggest that the agent use a template that describes each product in terms of these characteristics, along with an accompanying illustration. Let's consider each characteristic.

Premium flexibility. This characteristic presents the fundamental question of whether the premium is determined by the carrier (and therefore the agent) or the client. It's difficult to assign too much importance to this question, because the presence or absence of control over the initial and ongoing premium could well be the deciding factor for or against the choice of a type of policy. For example, a younger individual who would like to buy a cash value policy to supplement some term insurance might want to be able to "feather in" the premium as his compensation increases, without evidence of insurability. Or, an individual who's funding a policy in an irrevocable life insurance trust (ILIT) might want to pick up the pace of that funding or, conversely, cut it back for a while to conserve cash or gift tax exemption, without losing any death benefit. Or, consider the 60ish-year-old policyholder with a health issue who wants to increase the funding of his policy for retirement purposes. A flexible premium policy such as CAUL would accommodate him, but other types of policies, such as WL, wouldn't. He would be forced to go back into the marketplace, if he even could. On the other hand, many individuals would prefer not to have that kind of flexibility, perhaps because they want or need the discipline of a fixed premium to make sure the policy is funded properly. These individuals would likely be more comfortable with WL or GUL.

In practice, there are two main points to appreciate about premium flexibility. First, many agents are reluctant to give the client that kind of flexibility and control over the pricing decision. That's because it either puts the compensation in the hands of the buyer or creates a product with performance risk, service demands or both that they aren't comfortable selling. That's why a thorough discussion about these characteristics, and product suitability in general, is key to a purchase that will stand the test of time. Second, the individual had better understand that the price of having that flexibility is eternal vigilance, which is why the agent's post-sale service model is so important.

Premium guarantees. This characteristic, typically associated with WL, GUL and certain hybrid versions of

> Key to the whole story of WL is that as long as the insured pays the premium, the risk that the guarantees might not be met is borne by the carrier.

CAUL and VUL, is all about the extent to which the client wants to know that the premium he plans to pay will support the death benefit until a targeted age, regardless of policy performance. Guarantees obviously have their place in many planning scenarios in which the policyholder needs to know just what his premium outlay will be on an annual basis. That assurance may be necessary for cash flow planning for a personal policy or for gift tax planning for funding a policy in an ILIT. But, the prospective purchaser of a policy with a guaranteed premium must clearly understand what the guarantees will bring to and take away from the table over the life of the policy in terms of the other characteristics, for example, the premium flexibility afforded the owner of a CAUL or VUL policy versus a WL or GUL policy.

Investment flexibility. This characteristic, primarily associated with VUL, but also with EIUL to a limited extent, refers to the ability of the policyholder to designate how the policy's cash value is invested, all within the confines of the rules on diversification and investor control under Internal Revenue Code

Section 817. At first blush, this characteristic would seem to be of particular importance to individuals who think that they can "out-invest" the carrier. But, there may be other aspects of this characteristic that appeal to the policyholder. For example, an individual might perceive that a separate account product, such as VUL, in which cash value allocated to the funds isn't subject to the claims of the carrier's creditors, is safer than general account products like WL, CAUL, GUL or EIUL, in which cash values are subject to those claims.

Cash value accumulation/distribution. Individuals in high tax brackets may consider using cash value policies as vehicles for retirement investing, either on a standalone basis or as a component of their larger life insurance program. Or, individuals who use split dollar or other forms of premium financing may want to be able to use the policy's cash value to fund an exit strategy from that arrangement. Almost by definition, the investment-oriented purchaser will look for premium flexibility to accommodate what could be an irregular pattern of funding the policy, but wouldn't want guarantees that could limit that flexibility. Investment flexibility, however, may or may not be important to this type of policyholder.

EIUL can be appropriate when priorities are premium flexibility and the opportunity to benefit from performance of the equity markets with downside protection.

The four characteristics described are the foundation for selection of the type of policy. Once selected, however, the policy has to be designed, which will require the individual to consider such things as premium duration, that is, how many years he would like to plan on paying premiums, and death benefit structure, meaning level, increasing or return of premium. A standalone investment-purposed policy also calls for its own design specs, such as a minimum non-modified endowment contract (MEC) format or something that might accommodate increased funding in later years without underwriting.

WL

Traditional WL is so named because premiums are payable for the insured's whole life, though as discussed below, the policyholder may not have to make out-of-pocket premium payments for the duration of the policy. The product offers a fixed premium that may be level or modified, a guaranteed cash value and a guaranteed death benefit.

Key to the whole story of WL is that as long as the insured pays the premium, the risk that the guarantees might not be met is borne by the carrier. WL is designed to "endow;" that is, the premium is set to cause the policy's guaranteed cash value (unbuffered by dividends) to equal its guaranteed death benefit at age 121 (or thereabouts). The buyer has no say in the determination of the premium.

A participating WL policy might pay dividends. Dividends reflect the fact that the carrier had a better investment return, better mortality results, better persistency and lower expenses than the conservative assumptions made in determining the fixed, guaranteed premium. Thus, the dividend is merely a refund of the overcharge represented by the fact that the premium is set at the conservative guarantees, but the company's results are determined by much more favorable current experience. Dividends aren't guaranteed, either as to amount or even if they'll be paid at all. If paid, dividends can be applied in several ways, but are most commonly used to purchase paid-up additions, reduce the premiums or pay the policy owner in cash. Paid-up additions are small single premium policies purchased at net rates. Paid-up additions are themselves participating, so they generate cash value and death benefit above those guaranteed by the policy.

As noted, premiums are contractually payable for life. However, under some sort of so-called "vanishing premium" or "quick pay" scenario, an illustration may show them as payable for some shorter period. Regardless of what the outlay column in the illustration shows, the premium never actually goes away—it's just being paid out of policy values. Whether and when the policy will ever become self-sufficient in this fashion is a matter of pure conjecture. Indeed, vanishing premiums could reappear if the carrier's dividend scale drops sharply enough to require more cash contributions from the policyholder.

WL/Term Blend

This type of policy blends a base of WL with a term insurance component, for example, a $1 million policy is $200,000 of WL and $800,000 of term. The WL portion offers the guarantees associated with traditional WL for that portion of the death benefit while the term portion offers low cost (and lower commission) coverage.

Here's how the blended policy works. The total death benefit, the $1 million let's say, is comprised of the guaranteed death benefit from the WL, paid-up additional insurance from the WL dividends and the term insurance. Each year, the dividends buy paid-up additional insurance, which displaces some amount of term insurance until the term insurance is totally displaced. The premium is cheaper here than for a pure WL policy because the policyholder is buying only a portion of the death benefit at the guarantees and the balance at current rates. However, if the dividends drop and/or term charges rise, that displacement will take longer, perhaps much longer. In some cases, additional premium would be required to maintain the death benefit if dividends fall far enough and fast enough for long enough. So, to cushion the policy for adequate performance under lower dividend scales, policyholders commonly add a "paid-up additions rider" or use some other mechanism that accelerates the build-up of paid-up additions.

When creating the blended policy, designers typically minimize the base WL, maximize the term and add a generous amount of low commission paid-up additions rider or an essentially equivalent mechanism made available by the carrier to support the policy at a lower projected dividend scale.

CAUL

The quintessence of flexibility, CAUL, essentially allows the policyholder to "buy term and invest the rest" within the same policy, but retain the flexibility to change the outlay and literally reshape the policy to suit changing

SHARE this article
Click for more INSURANCE

circumstances. The carrier guarantees to credit a minimum interest rate to the cash value and to cap the cost of insurance (COI) at a certain level. Meanwhile, the carrier credits a current rate of interest and charges current COIs, that is, the current assumptions. Note the emphasis on "assumptions," because the interest crediting rate (above the minimum) and COIs may be changed within policy limits at the carrier's discretion.

In colloquial terms then, the carrier says to the prospective purchaser, "Tell us what you want to do. Do you want to plan on paying a premium that will merely keep the death benefit level to a certain age as long as our current COIs and credited interest are maintained? Do you want to endow the policy at those current assumptions or perhaps at a (more conservative) set of assumptions? It's up to you! And, by the way, if you start at a given premium, you can increase it (without evidence of insurability) or cut it back if the performance warrants, without our approval."

In exchange for this kind of flexibility, the policyholder must be vigilant, monitoring the policy annually to be sure the current premium (if any) is adequate to support the death benefit to the targeted age. That said, if the policyholder sees that, because crediting rates declined, COIs increased or both, he'll have to increase the premium to support the death benefit; it's his call whether to do so or by how much for how long.

Some carriers offer a means of blending the CAUL policy into base and term components. For example, a $1 million death benefit would be comprised of $250,000 of base and $750,000 of term. As a general rule, the term component will have lower loads than the base, as well as COIs that are equal to or less than the COIs in the base. Therefore, the strategy with this product is similar to the strategy for the WL/term blend described above; that is, minimize the base, maximize the term and pay as much of the premium in as "excess" premium or "dump-in" as possible.

GUL

This too is a flexible premium product like CAUL, but with key differences that can make it highly suitable for a given policyholder … or not.

GUL starts with the CAUL chassis, including current and guaranteed crediting rates and COIs. But, GUL then offers a secondary guarantee, under which the carrier guarantees that the policy will stay in force through a targeted age if a certain premium is paid, regardless of policy performance. The policyholder can choose the initial duration of that guarantee, which can be to a certain age or until policy maturity at age 121 or thereabouts. The prospective policyholder should be shown the difference in premiums associated with varying durations of the guarantee.

The advantage of GUL is that it allows the policyholder to lock in a premium that's guaranteed to support the death benefit for whatever length of time the policyholder chooses, thereby eliminating the performance concerns associated with CAUL (or any other performance-based type of product).

While nowhere near as flexible as CAUL, GUL will allow the policyholder to reduce the premium or skip it altogether, with the fairly obvious result, however, that the length of the guarantee could be shortened, perhaps considerably. Because the policyholder may subsequently want to re-extend the guarantee, the policy should allow for a catch-up, that is, the recalibrated premium guaranteed to support the death benefit to whatever the new targeted duration. In practice, a policyholder who's considering cutting back the premium (and knowingly cutting back the guarantee correspondingly) can get an illustration from the carrier that shows the catch-up premium.

As attractive as the no-lapse guarantee may be to the prospective policyholder, he should clearly understand these key differences between CAUL and GUL. First, CAUL offers tremendous premium flexibility (with the concomitant need to monitor the policy's performance on a regular basis). GUL calls for consistent and timely payment of the premium and a thorough understanding of how any grace period works. (Incidentally, there should be just as thorough an understanding of the implications of an early payment.) The advantage of premium flexibility shouldn't be taken lightly. While some policyholders think that they'll always be able to timely fund a policy with an annual premium until death (or the earlier targeted age), any number of things could happen on the way to presenting the death claim that might cause the policyholder to want to change (or suspend) the premium.

CAUL will generally build more cash value than GUL, perhaps materially. In many cases, this aspect of the product isn't material to the policyholder because he doesn't intend to access that value and is content to own

a product that's essentially like a level premium term insurance policy to whatever age the guarantee has been targeted. But, the absence of cash value could become problematic if the policyholder ever becomes unhappy with the product or the carrier; there will much less cash value available for an exchange than there would have been with a conventional product. The policyholder should also appreciate that GUL has no upside, meaning that unlike CAUL, in which an increase in the credited interest rate (or reduction in COIs) will eventually allow the policyholder to reduce the premium to support the death benefit, those kinds of changes will have no impact on the required premium for the GUL.

In recent years, the extended period of low interest rates has caused many carriers to either increase the costs of their GUL products, remove certain offerings from the marketplace or create hybrid GUL products (and IUL and VUL as well) that start out in a GUL format with a fixed premium for a given duration (usually to life expectancy), but then perform as a CAUL product thereafter. The cash value growth of this type of product can be significantly greater than for a pure GUL. The carriers market these products as maximizing the death benefit while minimizing the premiums. The durational guarantee products are illustrated based on current assumption (at market) crediting rates, while also showing the guaranteed (worst case) scenario. The risk with a durational guarantee product is if the insured lives beyond the guarantee period and the policy hasn't performed well on a current assumption basis, the premium necessary to support the death benefit to maturity could be substantially higher than the original illustrated. The policyholder must be comfortable accepting this risk in exchange for cash value accumulation, creating a viable exit strategy and upside participation should crediting rates increase over the duration of the policy.

EIUL

Essentially akin to CAUL, a flexible premium product with the same concept of current versus guaranteed COIs, EIUL takes another step by offering the opportunity to participate in the equity markets with upside limits and downside protection. With EIUL, the carrier credits the cash value with the greater of a minimum guaranteed rate or a portion of the growth of a given index, such as the S&P 500. To be able to provide both a floor and a ceiling on the crediting rate, the carrier uses some part of the account (perhaps as much as 10 percent) to invest in an index straddle—put and call options on the selected index. Note that even though crediting may be based on the equity markets, the product is still a general account product.

The crediting methodology typically involves the measuring period of the return, the return of the selected index, the cap or portion of the index's return that the carrier will apply in the crediting formula, the participation rate or percentage of the index's return (subject to the cap) in which the policyholder will participate and the floor or the minimum guaranteed return the carrier will credit, which might be 0 percent.

Consider this example. A policyholder has selected the 1-year S&P 500 (without dividends). In this policy year, the index returns 15 percent. The participation rate is 100 percent, but the cap is 11 percent. Therefore, 11 percent is credited. If the index had returned

9 percent, the carrier would have credited all 9 percent because there's 100 percent participation, and the cap is greater than the return. On the other hand, if the S&P had been down that year, the floor would protect the policyholder with a 0 percent return. Note that the carrier does charge expenses and COIs, so it's not really a 0 percent return.

EIUL is arguably more complicated a product than the others discussed here. So, it's critical for the policyholder to understand how the product works, which elements (for example, the participation rate and cap rate) are guaranteed and which ones the carrier can change and the impact of any such changes on performance and premium. Likewise, as with all products, the prospective policyholder should be provided with illustrations that assume different cap and participation rates, depending on which is guaranteed and which can be changed. Meanwhile, as noted earlier, some EIUL products can also offer death benefit guarantees similar to GUL. In short, EIUL can be appropriate when priorities are premium flexibility and the opportunity to benefit from performance of the equity markets with downside protection. As with any current assumption/performance-based product, regular monitoring is wise.

A rule of thumb is that term insurance is appropriate for needs that will last no more than 20 years (with gusts up to 30).

VUL

Like its general account siblings, CAUL and EIUL, VUL is a flexible premium policy that allows the policyholder to direct the investment of the cash value among separate investment accounts managed by the carrier (or an affiliate or independent money manager) offered under the policy. The product may also offer the carrier's general account as an investment option.

These are security-based policies. The policy itself is a security, because the lifetime values and (in some cases) the death benefit are determined by the investment choices made by the policy owner among the "funds." The funds (except for the guaranteed interest account) are separate accounts, generally not subject to the claims of the carrier's creditors in the event of insolvency. While this protection depends on the state law applicable to the carrier, most states (and many foreign jurisdictions) have such a law. By contrast, the general account of the carrier isn't such a separate account and, accordingly, is subject to claims of the carrier's creditors.

In exchange for the flexibility to direct the investment of cash value in the funds, the VUL policyholder takes on the risk of market loss and the burden of managing allocation of those funds. Hybrid versions of the product offer no lapse guarantees as well as the investment flexibility and growth potential of VUL.

Generally, the ideal setting for VUL is when the policyholder will: (1) minimize the death benefit relative to the premium, and (2) fund the policy rapidly. This approach reduces the net amount at risk and takes some (maybe a lot) of the volatility out of the product over time. The much less than ideal setting for VUL is when the policyholder wants to fund a large death benefit with a minimum premium!

As with other products, many VUL policies allow a blend of base policy and term as a way to reduce the premiums for the death benefit.

Practical Application

Let's apply what we've covered so far to some real life scenarios, meaning the kind of situations in which a client (or a colleague) might ask for your advice on everyday life insurance questions. Our premise is that an estate planner should be able to field these inquiries on at least a structural basis, meaning with some general rules, before getting to "It depends."

Life insurance for survivor income—a capital question. The classic role of life insurance is to provide financial security for survivors. And, the classic way to assess the need is to compare the needs that the survivors will have for capital with the sources of capital. The analysis compares the immediate needs for capital plus the sums that should be set aside and invested for future needs, less capital sources available at the individual's death. The result will be a capital need (or a surplus). As we take a closer look, it will become clear that the analysis is far more sophisticated and nuanced than it first appears.

Immediate needs include expenses, debts, mortgages, income taxes and estate taxes that would have to

be paid shortly after the individual dies. Some of these immediate needs are straightforward, others aren't. For example, should the individual plan on having enough life insurance so the survivor can pay off the mortgage(s) or just build that cost into the income needs? Anyone who thinks that's just a matter of the numbers probably hasn't had that discussion with clients (or with a spouse). Set asides include the present value of the funds to be invested for children's education and can include funds for resumption of education by the surviving spouse. Income needs are the present value of the amount of money that the surviving spouse and children will need (or want) on an annual basis. This need is a good example of how the analysis should be more sophisticated than it first appears, because their needs will change as the spouse and children get older. In addition, there's the issue of whether the survivor wants to live off of income only or consume principal as well.

Capital sources can include Social Security and other survivor benefits, including pension and other benefits from the individual's employer. The planner has to determine how much those benefits will be, when they'll start, whether they're adjusted for inflation and so forth. There's usually some existing life insurance, but the planner has to determine how much of it is payable in all events as opposed to only if death occurs at work or in an accident. The individual's (or couple's) investments are certainly a source of capital, but the planner has to help the individual determine an appropriate assumption for the after-tax return for the survivor's portfolio. If continuing tax deferral of such qualified accounts as an IRC Section 401(k) is desirable, will the survivor be able to afford to keep the money in the plan? Finally, if the individual's spouse currently works outside the home, to what extent will he be able to continue to do so? Of course, this topic then raises the issue of the cost of day care. And on and on…

We know the right amount, but now what? A rule of thumb is that term insurance is appropriate for needs that will last no more than 20 years (with gusts up to 30). If that thumb is on the hand of a conservative planner, the client who's inclined to buy a 15-year term policy should be advised to buy a 20-year policy. The cost difference isn't that much, but the 5-years' worth of protection could be worth its weight in gold if the client's plans don't gel as anticipated. Needs of greater duration should be funded with a cash value policy, which really just means some form of permanent product.

Clients will usually resist permanent insurance, but the planner should urge the client to look down the field, as it were, and think about what his financial picture looks like 15 to 20 years hence. The planner can be especially helpful by identifying the needs that many 55 to 60 year olds (still) have for life insurance and the difficulties that these individuals can encounter when they try to buy the coverage at that age. Then, the client's cash flow permitting of course, the planner can work with the agent to show how some cash value insurance can provide enduring coverage without enduring out-of-pocket cost.

The clinical case notwithstanding, most clients won't and shouldn't fill the entire prescription with permanent insurance. Perhaps they should consider a bifurcated approach, that is, a 15 to 20-year term policy for needs that will be met within that time frame and a cash value policy that will meet the longer term needs. The chief virtue of that approach is that it will remove the risks associated with term conversion, meaning that when the client might be ready to convert, the product(s) available for conversion may be expensive (because the carrier knows who'll want to convert) or may offer less design flexibility than the client wants. Meanwhile, if the client's health has deteriorated over the years, he might have little or no choice in the marketplace. So, if this bifurcated approach is of interest to the client, then the planner can ask the agent to show an illustration for a CAUL product that has a relatively low premium that the client can increase (without evidence of insurability) when and as the budget allows.

> As with other products, many VUL policies allow a blend of base policy and term as a way to reduce the premiums for the death benefit.

We took the liberty of identifying CAUL as the policy of choice here because the hallmark of the approach is going to be premium flexibility. Premium guarantees may be attractive at first blush, but could be

counter-productive over time for a (particularly younger) client who might need that flexibility budget-wise now and, in later life, want to use the policy as an investment vehicle. Cash value accumulation won't be relevant at the outset because the client will be looking to keep the premium so low relative to the death benefit. But, as funding possibilities pick up steam, then that use/application of the policy could be of interest. Investment flexibility is probably contraindicated early on because of the risks associated with minimum funding of a policy that could be volatile if returns are subject to the markets, directly or otherwise. But, the client may be interested in a policy that offers both a general account and the opportunity to allocate cash value to the capital markets once funding can be more robust.

Pension maximization. Assume that a client calls to sound out your views on a proposal that she received from an agent. She tells you that her husband, a longtime executive of a major company, is going to retire in a couple of years and is just starting to consider his options for payout of his pension plan. Apparently, his pension is projected to be $250,000 a year. If he predeceases her, she'll get 50 percent of that for the rest of her life. But, if he takes a single life pension, meaning that she would get nothing if she predeceases him, then he gets something closer to $280,000 (projected). Some of the people he works with do this thing they call "pension max," in which they take the single life payout but buy life insurance to leave their surviving spouse enough cash to invest or buy a single premium immediate annuity (SPIA) to replicate the 50 percent survivor benefit. That's the deal. Your client would like to know what you think about that strategy.

First though, a little more background. The agent was very clear that the strategy will only make sense if the premium for the needed coverage is less than the after-tax difference between the single and joint pensions. The agent was also very clear that the strategy can harbor some risks for the spouse, primarily that the right amount of life insurance on (in this case) the husband is inherently unknowable. After all, the whole calculation is based on assumptions about key variables, such as how long each spouse will live, what the capital markets will return on the insurance proceeds and what a SPIA will cost at the time she needs to buy it. The point is that the strategy involves a lot of "ifs." The pension doesn't, though some might argue that the pension does indeed involve risk. For example, the husband's company could one day have difficulty maintaining the plan.

But, let's assume that the client and her husband would like to explore the strategy. Let's further assume that the agent has conservatively determined the amount of insurance that the husband would need to replicate the survivor pension with, shall we say, reasonable downside protection. How easy it would be to implement this strategy if the husband had (followed the agent's advice and) purchased a cash value policy years ago. But, he didn't. So now, the task is quite a bit more daunting. That's because, depending on his health, the premium for a cash value policy that provides the considerable amount of insurance the husband will need could well be greater than the after-tax difference between the two payouts.

In this scenario, which isn't altogether uncommon because many executives first consider their pension options shortly before retirement, a reasonable approach might be to bifurcate the coverage, that is, mix some term with some permanent. For example, the husband could buy a 15-year convertible term policy for perhaps half of the need and a flexible premium CAUL or GUL for the balance. This approach would enable the couple to design the insurance portfolio in a cost-efficient manner, with plenty of opportunity to reshape the portfolio in later years. "By the way," you advise the spouse, "Be sure that you own the policy!"

Incidentally, even when couples, such as the one in our example, decide against using pension maximization, the exercise itself can illuminate the need for some additional life insurance on the husband (or maybe even the wife). While the husband might not buy as much as he would have if he did the pension maximization, he might still buy some insurance to hedge against the risk of the company's faltering on the pension. And, even if that risk is negligible, the couple might decide that, pension notwithstanding, the wife would feel a lot more secure if the husband had more coverage going into retirement.

Life insurance as an investment. We wrote on this topic in 2013,[1] and much of that article is incorporated here by reference. Perhaps the only thing that's changed since then is that, under current proposals, high bracket taxpayers may end 2017 as somewhat lower bracket taxpayers, which is a headwind for cash value life insurance as an investment vehicle. Beyond that, it remains to be seen whether this concept/application has more going for it than against it, primarily because:

- Clients may be reluctant to take a physical, though this will be much less of a concern if the policy will be needed anyway for family security.
- The client realizes that, at the end of the day, the tax rules that offer the deferral and the tax-free access to the cash value become seriously constraining when he really wants to use the policy, reshape it or get out of it altogether.
- Given the need for efficiency of both cash value accumulation and distribution, the interests of an informed buyer may not align well with the interests of an informed seller. In fact, they could be irreconcilable.

But, if the client is going to explore this use of insurance, he'll be well advised to demand that the discussion about the tax aspects of this application not monopolize the conversation. The planner should work with the agent to illuminate for the client the nuances of policy selection (based on the above-described characteristics), components of and risks to pricing and the practical guidelines for premium funding, death benefit design and the timeline and guidelines for tapping the policy for cash. The mission should be for the client to understand how the policy works and what and how things can go right and can go wrong, whether it's with the carrier, the policy or the agent.

Meanwhile, no type of policy has a monopoly on functioning as an investment-oriented vehicle. Any cash value policy other than a pure GUL can serve in this capacity, though premium flexibility can begin to suggest one type over another in a clinch.

Life insurance for estate liquidity (or maybe not). In light of the potential for repeal of the estate tax, many individuals who were considering the purchase of life insurance for estate liquidity (and only for that purpose) are now reconsidering that notion. While these individuals could easily postpone the purchase until there's some clarity to the estate tax picture, postponement courts the risk of loss of insurability in the meantime. So, rather than applying for a heavily funded permanent policy that would potentially involve a lot of unrecoverable sunk cost, they could consider setting up an ILIT and having the trustee apply for a convertible term insurance policy. The term policy would protect their insurability, and the conversion feature (if well designed) would enable them to go long on the coverage when and if the time is right. Meanwhile, if the estate tax is repealed, they can just stop funding the premiums (or maintain the coverage through an election or two). One caveat to this approach is that it involves conversion risk, which can be avoided by having the ILIT instead buy a flexible premium product and fund it at the minimum premium to support the death benefit for a while, somewhat mimicking the term policy approach. Then, if there's a need to go long, the insured can just increase the funding without evidence of insurability (and without the risks of conversion). In larger cases, you'll want to consider diversifying the coverage, regardless of which approach you take.

Life insurance in collateral assignment (loan regime) split-dollar arrangements. We published an article on this technique for financing premiums,[2] and it too is incorporated herein by reference.

SPOT LIGHT

Let's Dance

"La carte à jouer" by Émile Chambon, sold for $13,792 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017. Chambon faced a major road block before his career even took off—the highly acclaimed École des Beaux-Arts almost didn't accept him because the school's director felt his family wasn't wealthy enough to allow him to pursue an artistic career.

So, assuming the client understands the potential risks and pitfalls of split dollar or any leveraged approach that one would categorize as "multi-factor dependent," it will then be important for the client to address these questions to begin to inform policy selection and design:

- Should the ILIT's death benefit remain level net of the loan, perhaps by using a return of premium rider?
- Will loan interest be paid currently or accrued?
- If there's an exit strategy that doesn't involve the client's death, will the policy's cash value be used to repay some or all of the loans?

Depending on the answers to the above questions (and other aspects of case design), premium flexibility may again be the most helpful characteristic of the policy, for example, to minimize the loans in the early years while the ILIT is being funded with discounted gifts, grantor retained annuity trusts and other techniques. Efficient distribution of cash value in subsequent years (perhaps to pay loan interest or assist in the rollout) could also be an important consideration.

While having less to do with policy design than politics, use of split dollar with a permanent policy in the near term doubles down on the risks of incurring unrecoverable sunk costs and then having to deal with loans that still (likely) have gift tax implications because that tax isn't repealed.

Life insurance as a trust investment. Life insurance is often touted as a worthy investment for ILITs, notably dynastic ILITs. The concept is that an individual would establish a dynastic ILIT and fund it with remaining gift and generation-skipping transfer tax exemption so that the ILIT could purchase a policy for pure wealth transfer. Depending on the insured's life expectancy, the internal rate of return on the policy's death benefit can be attractive on a risk-adjusted basis.

We often see GUL proposed in this space, largely because of its guaranteed return. We also often see second-to-die policies proposed because they appear to be cheaper than coverage on one of the spouses individually. As we've noted before, the GUL product may not be the most attractive one, largely because its absence of robust cash value could deprive the ILIT of a valuable (and tax-efficient) asset for decades. Also, when the policy will insure two relatively younger spouses, whose deaths could be separated by decades, it may make more sense to insure one of them (even for a lower face amount) than to risk a scenario in which the first insured dies proximately, the survivor has to continue to fund the policy and the ILIT has nothing but carrier risk for decades.

—Portions of this article were presented at a workshop given by the authors and Mary Ann Mancini of Loeb & Loeb LLP at the 51st Heckerling Institute on Estate Planning in Orlando, Fla.

Endnotes

1. Charles L. Ratner and Lawrence Brody, "Life Insurance After ATRA," *Trusts & Estates* (April 2013), at p. 40.
2. Lawrence Brody and Charles L. Ratner, "Today's Split Dollar," *Trusts & Estates* (May 2007), at p. 38.

SPOT LIGHT

Fishy

"Composition à l'oeil" by Léopold Survage, sold for $15,325 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017. Although he was mainly a painter, Survage notably designed textiles for the Chanel fashion house in the 1930s. He frequently rubbed shoulders with many of the greats—he shared a studio with Modigliani and briefly attended Matisse's art school.

FEATURE: PERSPECTIVES

By Thomas E. Greene III

Public Policy Interests of Domestic Asset Protection Trusts

These vehicles can offer benefits without violating creditors' rights

Self-settled discretionary spendthrift trusts, also called domestic asset protection trusts (DAPTs), are irrevocable trusts in which the settlor is designated a discretionary beneficiary. In general, DAPT structures offer settlors emergency access to trust assets, while making it more difficult for certain creditors to seize the assets. Other benefits include ensuring privacy, possible tax savings, flexibility to modify the trust if family circumstances change and the avoidance of intrafamily quarrels. Importantly, residents of states that haven't enacted DAPT legislation may also take advantage of the potential benefits of DAPTs by designating, as the trust's governing law, the law of a state that recognizes DAPTs. To help ensure that such law is respected, the settlor must take a variety of structuring and statutory steps, including choosing a trustee that's located in the governing law state.

In spite of these benefits, it would assault our collective sense of fairness if an individual were able to take on a legitimate debt and then, by the contrivance of shoveling his assets into an irrevocable trust, avoid repaying that debt. And, we would be equally offended if another individual, contemplating a risky business endeavor, could make his assets unavailable to the enterprise by transferring them into a trust. Fortunately, our moral antennae needn't be on constant alert, as these types of abuses are well covered by both state and federal fraudulent transfer laws, which uniformly give creditors the right to void such transfers. In contrast, DAPTs are concerned with future creditors and unanticipated events. The logic behind this critical distinction was stated clearly by the U.S. Supreme Court in *Schreyer v. Scott*: "[the settlor] had done no more than any businessman has a right to do, to provide against future misfortune when he is abundantly able to do so."[1]

Nonetheless, there's been a troubling pattern in some of the DAPT cases that have gone to court. Faced with financial stress, some planners and their clients have launched desperation DAPTs, usually involving a fraudulent transfer. Troubled by the specter of abuse, some courts and legislatures have searched for ways to render equitable relief.[2] In fairness, these cases are in court for the very reason they're troubling, but a more powerful analytic is at work. In practice, different creditors' claims raise different sorts of policy concerns. In a complex commercial environment, a "one size fits all" rule may not be practical or desirable. In his thoughtful article on the subject, law professor Dr. Adam J. Hirsch considered the competing arguments and concluded "that the fundamental principles of asset protection doctrine are, in point of fact, compatible with public policy."[3]

A More Reasoned Perspective

Until the creation of the first DAPT in Alaska in 1997,[4] the absolute transfer prohibition of the self-settled trust rule represented the state of U.S. law. But, as society became increasingly litigious and the effectiveness of some long-standing asset protection techniques was called into question,[5] it was inevitable that planners and their clients would look to DAPTs as possible solutions. There are now 17 states that allow DAPTs,[6] and new states seem to be added each year. Although the debate between DAPT supporters and self-settled rule proponents is ongoing, a look "under the hood" at the public policy issues surrounding DAPTs shows that these vehicles serve rather than harm the public interest.

Thomas E. Greene III is founder of Liberty Street Advisory Group in Athens, Ga.

Right to Asset Protection Planning

In their article, "Asset Protection Trust Planning," estate-planning attorneys Duncan E. and Mark E. Osborne assess the critical environment for DAPTs:

> While proclamations from the ivory tower have occasional value for the practitioner, it is far too easy for a legal purist peering down from high aloft to focus on a few instances of flagrant abuse …, stake out a position of moral outrage, and then universally condemn anyone who dares to engage in asset protection planning.[7] Although perhaps satisfying their sensibilities and finely-honed sense of moral rectitude … such a reaction is simplistic, unhelpful and unsupportable after even a cursory look at the asset planning abuse protections already well-established in the law…
>
> Almost all estate planning lawyers, almost all of the time, represent honorable, law abiding clients, men and women who daily contribute to society by their productivity and with their generosity, who pay their bills and their taxes, and who are not deadbeats, cheats, frauds, or criminals. These same good people, some of whom have acquired significant wealth by their own hard work or that of their forebears, are legitimately concerned about the excesses of an American litigation system which sometimes more resembles a lottery-like payoff game than it does a reliable forum for the settlement of genuine claims.
>
> **TOM HANKS SLAPPED WITH LAWSUIT OVER SON CHET'S CAR CRASH**
> Entertainment, The Wrap, Tim Kenneally,
> Mar 29th 2016 10:09 AM.
>
> 'Chester Hanks was driving his vehicle in an unreasonable and unsafe manner and was under the influence of alcohol and/or drugs at the time his vehicle struck Mr. Moogan's vehicle,' the suit claims. According to the complaint, Tom Hanks and his wife, Rita Wilson, own the vehicle that Chet was driving. 'Despite knowing that Chester Hanks was a careless and reckless driver they negligently handed him the keys,' said Moogan.
>
> Let's be clear on this notion of duty. Even if some estate planning attorneys resist the idea, you can be assured the plaintiffs' bar will not. The next wave of creative malpractice actions could well be against estate planning attorneys who fail to advise clients about asset protection alternatives, filed by clients who have suffered financial reverses which could have been avoided with such planning.[8]

The benefits of DAPTs to settlors are real and substantial.

Most Substantial Relationship

Typically, DAPTs are created in a state with enabling legislation, but the settlor is domiciled in a non-DAPT state. When courts are called on to determine the legal sustainability of a DAPT, a number of considerations will come into play, but the most important is whether the trust has its most substantial relationship to the trust state or the non-resident settlor's state of domicile. A properly established DAPT will have all possible significant relationship factors tied to the trust state, so it stands to reason that the trust state's laws should govern. For a practitioner, it's essential to carefully establish and document the all-important relationship of the trust to the trust state, as the issues of jurisdiction, enforcement under the full faith and credit clause and choice of law may all turn on variations of this singular point.

Not All Cases Involve Abuse

Each trust is different, and the same brush shouldn't tar all cases. A properly used DAPT presents facts so dissimilar to instances of abuse, in both intent and fact, it demonstrates that individual cases can and should be distinguished and justice served to all parties. For example, critics of the DAPT like to point to *In re Huber*,[9] a case in which the trust was breached, ignoring the damning case facts: (1) the debtor was threatened with litigation when the transfers occurred; (2) the transfers were of substantially all of the debtor's assets; (3) the debtor retained control of the transferred

property; (4) the transfer from the debtor to the trust was to an insider; and (5) the debtor was attempting to remove the assets from the reach of his creditors. The transfer was clearly fraudulent and void. But, as to the *Huber* court's holding of relevant precedential interest (regarding choice of law), in spite of the bad facts, the court applied the law of the non-resident settlor's state and held for the creditor but only because the settlor's home state (not the trust state) had the most substantial relationship to the trust. This wouldn't be the case with a properly established DAPT.

Non-Asset Protection Benefits

The benefits of DAPTs to settlors are real and substantial. For example, depending on the settlor's needs and domiciliary state, there may be significant state tax savings and/or asset "freeze" opportunities. Further, you can draft a DAPT to provide for intra-family privacy, thereby avoiding generational quarrels. And, should the family's circumstances change, there can be flexibility to modify the trust. The settlor's potential opportunities are so significant that it seems fair to ask: "If DAPTs are sustainable in the face of legal challenge, do the attorneys of non-resident settlors have an obligation to discuss with their clients the pros and cons of designating a DAPT state as their trust jurisdiction?" The proper answer may be: "Why not, particularly if creditor protection is of no consequence to the settlor?"

Fraudulent Conveyance Protections

To what rights should pre-existing voluntary creditors be entitled? Should debtors be able to make risky loans and then render themselves judgment proof? The answer is no, but the question is a red herring. Fraudulent conveyance law affords the basic protections that every unsecured creditor presumably would insist on to make any loan agreement viable. And, under all of the existing domestic statutes, fraudulent conveyance law applies to the creation of a DAPT.

Further, protection for creditors from fraudulent conveyances has been strengthened by the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act,[10] which acknowledges the legitimacy of DAPTs by: (1) deferring the authorization and regulation of such trusts to the individual states' legislatures, and (2) specifically approving the right of bankruptcy estates to "claw back" assets fraudulently transferred into self-settled trusts.

Legislatures' Motives

What are the legislative motives for enacting DAPT legislation? Typically, states are looking for trust business. As Dr. Hirsch admits:

> The driving force behind these legislative initiatives is clear enough. States are vying for trust business. We cannot, however, condemn these marketing statutes merely because their motives are impure … Policy developments and time may yet vindicate the vehicles they authorize … much as its close relative and doctrinal progenitor, the spendthrift trust, once did.[11]

Another keen example is the history of states competing for industry by offering tax-exempt bonds and other monetary incentives to companies bringing employees into their states.

DAPTs Aren't Deceptive

If DAPTs were deceptive, creating a false appearance of creditworthiness, creditor confidence would wane, and markets would suffer. Fortunately, no risk of deception arises, because there's no appearance of the debtor continuing to own any of the assets in the trust. Trustees must segregate and earmark the assets to distinguish them from the settlor's assets. None of the leading trust state statutes depart from this fundamental trust principle. "Hence, DAPTs are not stealth vehicles, invisible to radar."[12] Their existence will be clear from a cursory review of a modern lender's credit application, and a failure to disclose will constitute a definitive badge of fraud under the fraudulent conveyance statutes, as well as run afoul of federal banking laws.

Involuntary Creditors

The most thought-provoking public policy issue facing the asset protection doctrine is presented by the following hypothetical scenario: A DAPT is created when the waters are calm for tax advantages, trust flexibility and to guard against unforeseen, but conceivable, involuntary creditors' claims. Later, there's a car accident. Certainly, the settlor can't be accused of fraud because no claim or expectation of a claim had arisen when the trust was executed. Therefore, if a DAPT is properly established and otherwise sustainable, the trust should be a barrier to the claim.[13] Should this prospect sound alarm bells?

Already, most states consider many techniques that

provide some degree of creditor protection to be sound public policy. Examples include: individual retirement accounts, life insurance, annuities, homesteads, tenancies-by-the-entirety and Internal Revenue Code Section 529 plans. Some of these are already self-settled trusts. Should DAPTs be treated differently? Does the settlor's potential to be protected encourage dangerous acts? It seems doubtful, as dangerous behavior also poses risks to the settlor and others. For professionals, their reputations, practices and incomes are strong incentives for occupational caution. Generally, public policy favors the free alienation of property. Is this a logical situation to restrict alienation? Clearly, these are philosophical questions about which honorable people can disagree, but the fundamental issue hasn't changed since *Schreyer*[14] resolved it in 1890. In short, how can the settlor be accused of fraud since no claim or expectation of a claim had arisen when the trust was executed?

DAPTs can offer protection or the opportunity for a fair settlement (of potential liabilities).

Creditors' Rights

As cited in the Osborne article mentioned above,[15] Professor Robert T. Danforth of Washington and Lee University School of Law published a balanced, provocative and insightful article on creditors' rights and trust law in the *Hastings Law Journal*. Prof. Danforth took aim at the lack of independent rationale and legal theory behind the rule against self-settled trusts, as espoused by Prof. Austin Wakeman Scott's treatise and the *Restatement (Second) of Trusts* (for which Prof. Scott was the reporter and principal author):

> Professor Danforth's most provocative and significant conclusion stems from his examination of the tautological maxim of American law that one cannot create a self-settled spendthrift trust. Professor Danforth points out that … neither source offers a solid, independent rationale or theoretical basis for the rule. Moreover, and most interesting, the cases cited by Professor Scott do not, in fact, support the rule as he lays it out. As Professor Danforth gently remarks about these cases, it seems that '[Professor Scott] read them somewhat generously in support of his position.'
>
> Professor Danforth further argues that the rule against self-settled spendthrift trusts, as espoused by Professor Scott, is not based on sound legal theory for a number of reasons. First, the rule ignores the rights of non-settlor beneficiaries, since the creditor can defeat the interests of those beneficiaries as well as the interests of the settlor. Second, it assumes a collusion between the settlor and the trustee, in which the trustee will blindly comply with the settlor's bidding, ignoring the legal obligations of fiduciaries. Third, it grants creditors greater rights than the settlor, since the creditor can compel distributions and the settlor cannot. Finally, the rule fails to distinguish situations in which the creditor retains a power of disposition from those in which the settlor does not.

Incongruous Results

Because the settlor no longer owns the DAPT assets, before the local court can issue a valid judgment, constitutional due process requires that the court obtain jurisdiction over the trust itself. The gravamen is that so long as the trustee doesn't have substantive contacts with the settlor's home state, there's no local jurisdiction, and due process won't be met.[16] This precedent makes common sense because theories for local courts exercising expanded long-arm jurisdiction can meet with unexpected public policy results. Consider two scenarios proposed by Prof. Ralph U. Whitten:[17] (1) If State X were to issue a license to carry a concealed weapon to someone in State X, all other states would have to allow the licensee to carry a concealed weapon within their borders, as a matter of full faith and credit. (2) Similarly, if State Y decided to issue driver's licenses to 10-year olds, all other states also would have to allow State Y 10-year old license holders to drive within their borders as a matter of full faith and credit. Although these scenarios (at least the second) may seem extreme, it's easy to imagine real world cases in which court procedure and a particular court's notion of public policy collide.

Reasons of Policy?

Dated model codes have withheld their approval of DAPTs or advanced the notion that they're against public policy without explaining just how they're against it. Essentially, the drafters who ingrained the rule in the *Restatement of Trusts* have left the substantive defense of their stance to our imaginations.[18] And, unless model lawmakers can spell out their rationales, how can actual lawmakers assess these rules?[19] Consider a bank operating in a competitive credit environment. As a matter of policy, shouldn't this voluntary creditor be free to reach any agreement it desires without interference from lawmakers and courts? "Those creditors who desire more protection can get it by demanding a security interest or additional contractual restrictions on debtors' behavior as a condition of the loan."[20] If the transfer to a DAPT downgrades a sound borrower into a poor credit risk, then the bank simply can deny the credit. Shouldn't legal regulation be restricted to situations in which market imperfections create inefficiencies or in which market participants are prone to make systematic errors of judgment? Why should the legislature or the courts intervene to protect the more sophisticated party to the contract?

Trustee Enforcement

Restatement (Second) of Conflict of Laws Section 270 states this doctrine: An inter vivos trust in movables is valid if valid under the law of the state designated by the settlor to govern the validity of the trust, provided that the application of its law doesn't violate *a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship* (emphasis added).

The U.S. Supreme Court examined this "public policy exception" in *Baker v. General Motors Corp.* for public acts (for example, statutes).[21] *Baker* is authority for the principle that a state won't be forced to enforce another state's public policy at the expense of its own public policy. The court in *Baker* noted, "The Full Faith and Credit clause does not compel 'a state to substitute the statutes of other states for its own statutes dealing with a subject matter concerning which it is competent to legislate' (quoting *Pac. Emp'rs Ins. Co. v. Indus. Accident Comm'n*, 306 U.S. 493, 501 (1939))."

In another context, an article by lawyer Elizabeth Redpath commented:

> The idea that one state, by the imposition of contrary public policy, can undercut the privileges conferred by another state is admittedly discomforting, but it is the lesser of two evils. Without the public policy exception, full faith and credit could mandate outcomes that are unfathomable to the majority of Americans … In other words, although the public policy exception can delay the spread of popular public policy, it can also forestall the spread of unpopular public policy. More critically, if states are going to continue to serve as laboratories for new social and economic experiments, then every state—the 'trial' states and the 'control' states—must remain sovereign … Horizontal federalism is based on the assumption that separate sovereigns achieve great economic and social progress. And separate sovereigns are neither separate nor sovereign without the power to make and enforce their own domestic policies. The Full Faith and Credit Clause should fit within this context.[22]

Other Policy Support

There are other DAPT policy considerations, which, while important, are self-explanatory. These include:

1) Much of the world already allows self-settled trusts;
2) Trillions of dollars have/are moving to these jurisdictions;
3) DAPTs create economic incentives and encourage entrepreneurship;
4) DAPTs preserve U.S. business;
5) DAPTs allow for U.S. oversight; and
6) It's illogical that outright gifts are allowed, but DAPTs aren't.

Serving the Public Trust

In today's world, doctors, lawyers, high risk professionals and high-net-worth individuals have just cause to be concerned about future liabilities. DAPTs can offer protection or the opportunity for a fair settlement. And, so long as the structure is set up properly far in advance and without knowledge of a unique business risk or creditor problem, the public trust will be served.

Endnotes

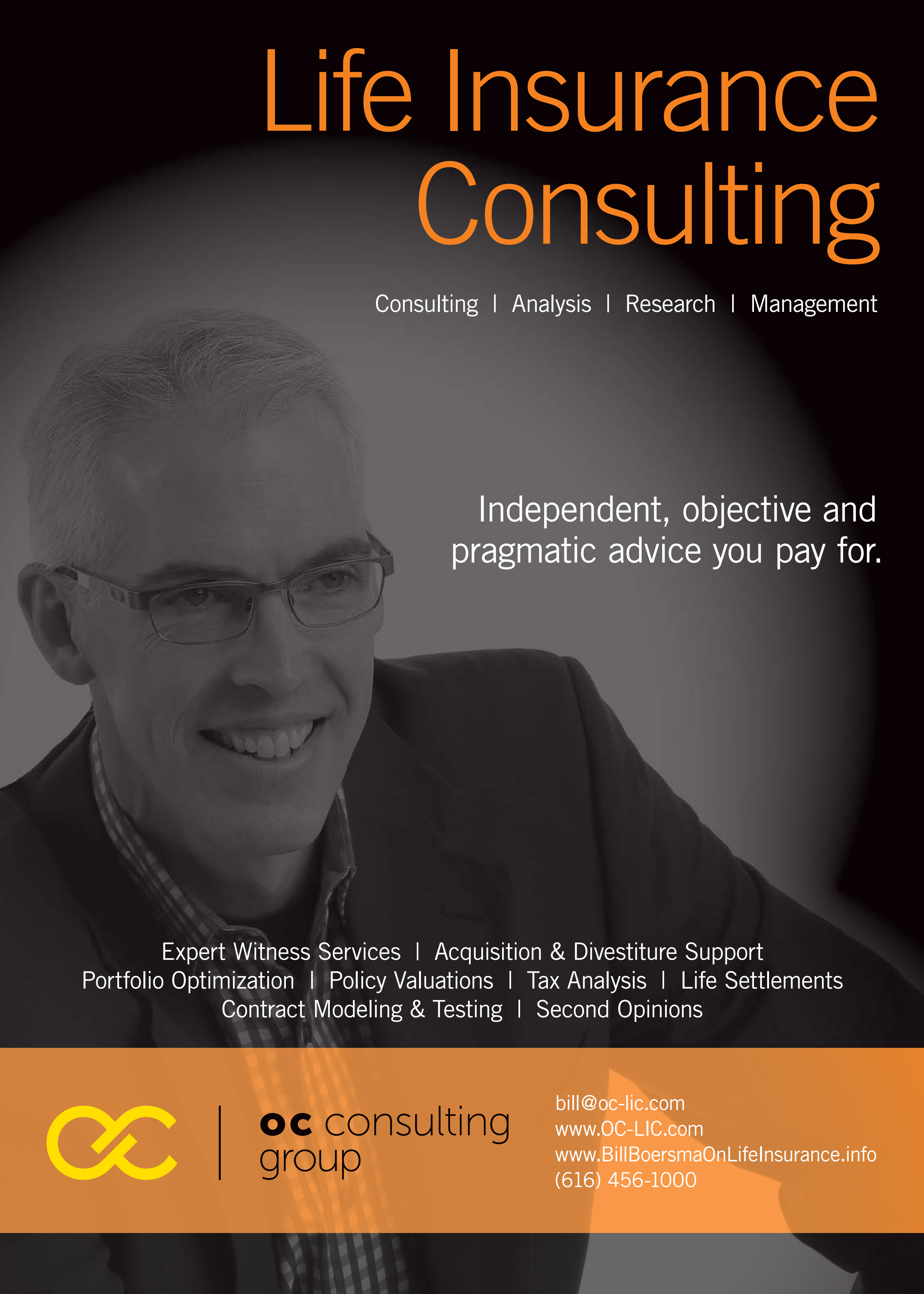
1. *Schreyer v. Scott*, 134 U.S. 405, 409 (1890).

2. One approach has been to rely on the ancient and absolute transfer prohibition of the self-settled trust rule (as distinguished from the fraudulent transfer rule), which entered the common law under the reign of Henry VIII's father, Henry VII. Over the centuries, the self-settled trust rule found its way into our trust law, with states using differing methods to void transfers to a trust in which the settlor retains a beneficial interest.
3. *See* Adam J. Hirsch, "Fear Not the Asset Protection Trust: I. Variations on a Theme," *Cardozo Law Review* (January 2006), at p. 2686.
4. *See* Alaska enabling statute Sections 34.40.010 to 34.40.13 (first U.S. state self-settled trust statute, post amendments).
5. For example, in 2002, the U.S. Supreme Court held that a spouse's interest in tenancy-by-the-entirety property was subject to a federal tax lien. *See U.S. v. Craft*, 122 S.Ct. 1414 (2002). In 2005, the bankruptcy law was changed, negatively affecting the treatment of retirement plans, homesteads, individual retirement accounts and domestic asset protection trusts (DAPTs).
6. *See* Steven J. Oshins, "7th Annual Domestic Asset Protection Trust State Rankings Chart" (April 2016) (States by rank: Nevada, South Dakota, Tennessee, Ohio, Delaware, Missouri, Alaska, Wyoming, Rhode Island, New Hampshire, Hawaii, Utah, Virginia, Oklahoma, Mississippi, West Virginia). Colorado has limited elements of a self-settled spendthrift trust (Colo. Rev. Stat. Section 38-10-111), but doesn't meet ranking qualifications. Michigan enacted legislation in Fall 2016.
7. What's a limited liability company, after all?
8. *See* Duncan E. Osborne and Mark E. Osborne, *Asset Protection Trust Planning*, The American Law Institute Continuing Legal Education with CLEW (June 2005).
9. *In re Huber*, 201 B.R. 685 (Bankr. W.D. WA May 17, 2013).
10. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. 109–8, 119 Stat. 23, enacted April 20, 2005, is a legislative act that made several significant changes to the U.S. Bankruptcy Code.
11. *See* Hirsch, *supra* note 3, at pp. 2687-88.
12. *Ibid.*, at p. 2689.
13. There's yet no case law on point; therefore, the assertion is the author's, based on legal and factual deduction. *See* Thomas E. Greene III, "Well-Crafted Self-Settled Trusts Formed by Nonresident Settlors Will Withstand Legal Challenge," *LISI Asset Protection Newsletter* #328 (Aug. 17, 2016) and generally, Richard W. Nenno and John E. Sullivan, "Domestic Asset Protection Trusts (Portfolio 868)," Tax Management Portfolio; David G. Shaftel and David H. Bundy, "Part I. Domestic Asset Protection Trusts Created by Nonresident Settlors," *Estate Planning* (April 2005); and Hirsch, *supra* at note 3, p. 2690.
14. *Schreyer*, *supra* note 1.
15. *See* Osborne, *supra* note 8.
16. *See Hanson v. Denckla*, 357 U.S. 235 (1958); *Rose v. FirStar Bank*, 819 A.2d 1247 (R.I. 2003); *In the Matter of Estate of Ducey*, 787 P.2d 749 (1990). *See Restatement (Second) of Conflict of Laws* Section 104 cmt. a. *See Wilkes v. Phoenix Home Life Mut. Ins. Co.*, 902 A.2d 366, 382 (Pa. 2006); *Estate of Waitzman*, 507 So.2d 24, 25 (Miss. 1987); *Underwriters Nat. Assurance Co. v. North Carolina Life & Accident & Health Ins. Guaranty Assn.*, 455 U.S. 691, 705 (1982).
17. Ralph U. Whitten, "Full Faith and Credit for Dummies," 38 *Creighton L. Rev.* (2005), at p. 477. *See infra*, Redpath, note 22.
18. *See* Hirsch, *supra* note 3, at pp. 2697-98.
19. *Ibid.*, at p. 2698.
20. *Ibid.*, at p. 2688.
21. *Baker v. Gen. Motors Corp.*, 522 U. S. 222, 233 (1998). The case law distinguishes "public acts," (for example, statutes) from monetary judgments to which the public policy exception doesn't apply.
22. *See* Elizabeth Redpath, "Between Judgment and Law: Full Faith and Credit, Public Policy and State Records," *Emory Law Journal* (January 2013), at p. 639, discussing *Adar v. Smith* (*Adar I*), 597 F.3d 697, 701 (5th Cir. 2010), *rev'd*, 639 F.3d 146 (5th Cir. 2011) (en banc), *cert. denied*, 132 S.Ct. 400 (2011). Although *Adar I* involved the problems of a gay couple attempting to correct the birth certificate record of their adopted child after moving to a different state with a public policy opposing gay adoptions, policy consistency argues that the fundamental full faith and credit principles are applicable.

SHARE this article
Click for more ESTATE PLANNING

HEIR TRACERS

wealthmanagement.com


Life Insurance
Consulting
Consulting | Analysis | Research | Management
Independent, objective and
pragmatic advice you pay for.
Expert Witness Services | Acquisition & Divestiture Support
Portfolio Optimization | Policy Valuations | Tax Analysis | Life Settlements
Contract Modeling & Testing | Second Opinions
oc consulting
group
bill@oc-lic.com
www.OC-LIC.com
www.BillBoersmaOnLifeInsurance.info
(616) 456-1000