



Planning in Uncertain Times Part 1

An article by Bob Finnegan, J.D., CLU, *HCB Senior Vice President, Advanced Sales Attorney*, published in Steve Leimberg's Estate Planning Newsletter on December 20, 2016

"Since at least 2001 when the estate tax was renamed the "death tax," transfer taxes have been a political football. With the election of Donald Trump and a 51-member majority in the Senate, the possibility of repeal has become more likely. Much of the commentary has taken repeal as a given. But is repeal likely? And if the transfer taxes are repealed, what is the likelihood that repeal will in fact be permanent? And most importantly, how do we advise our clients in the face of all of this uncertainty?"

If we step back and think about the prospect of repeal, nothing has really changed from before the election except client and advisor perceptions. There has always been a cloud of uncertainty hanging over the transfer tax system. The need to plan for tax as well as non-tax reasons is just as important today as it was six months ago, and as it will be in six months, 10-years or 20+ years. Consider that the environment for wealth transfer has never been better, and that the cost of delay can be substantial (covered in Part II of this Newsletter). Should your clients sit on the sidelines due to a false sense of security that estate taxes are permanently going or have permanently gone away? In fact, the uncertainty we are living with now could become the new normal and this can be an opportunity for us to become better planners by designing and implementing superior and flexible plans for our clients and their families."

LISI has provided members with significant commentary on the impact the election of Donald Trump could have on estate planners and their clients:

- Estate Planning Newsletter #2478 Jonathan Blattmachr & Martin Shenkman: Trump Wins, Republicans Control House and Senate, A Brave New World for Estate Planners
- Estate Planning Newsletter #2489, Jonathan G. Blattmachr & Douglas J. Blattmachr: Even Without Estate Tax the Right Answer Is Still the Same, Put It All in Trust
- Estate Planning Newsletter #2491, Martin Shenkman and Jonathan Blattmachr: Not So Hard to Figure: The Critical Importance of Current Continuous Estate Planning

Now, Bob Finnegan provides LISI members with his perspective on this important development.

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Here is his commentary:

EXECUTIVE SUMMARY:

Since at least 2001 when the estate tax was renamed the “death tax,” transfer taxes have been a political football. With the election of Donald Trump and a 51-member majorityⁱ in the Senate, the possibility of repeal has become more likely. Much of the commentary has taken repeal as a given. But is repeal likely? And if the transfer taxes are repealed, what is the likelihood that repeal will in fact be permanent? And most importantly, how do we advise our clients in the face of all of this uncertainty?

If we step back and think about the prospect of repeal, nothing has really changed from before the election except client and advisor perceptions. There has always been a cloud of uncertainty hanging over the transfer tax system. The need to plan for tax as well as non-tax reasons is just as important today as it was six months ago, and as it will be in six months, 10-years or 20+ years. Consider that the environment for wealth transfer has never been better, and that the cost of delay can be substantial (covered in Part II of this Newsletter). Should your clients sit on the sidelines due to a false sense of security that estate taxes are permanently going or have permanently gone away? In fact, the uncertainty we are living with now could become the new normal and this can be an opportunity for us to become better planners by designing and implementing superior and flexible plans for our clients and their families.

COMMENTARY:

We are in the sweet spot regarding wealth transfer:

1. Applicable Federal Rates governing intra-family transactions are extraordinarily low.
2. Discount strategies continue to be available.
3. Intentionally defective grantor trusts remain viable.
4. Gift/estate and GST exemptions are high & indexed for inflation.
5. Split dollar rules are extremely favorable and well defined.
6. Excellent life insurance products are available, including no lapse guarantee (NLG) products.

In short, these are the “good ole days”!

At the outset, it is fair to ask two fundamental questions:

- Why would a client sit on the sidelines and not take advantage of the most extraordinary wealth transfer environment we've ever seen?
- And why would an advisor advise or allow a client to sit on the sidelines at this time?

Clients will forgo planning they might otherwise have entered into if they believe better options (including doing nothing at all) are around the corner. In other words, they feel that transfer taxes including gift taxes will be permanently repealed. Likewise, an advisor may advise clients to defer planning only if they don't believe there are significant benefits to planning currently.

In exploring these questions, this newsletter will first consider President Elect Trump's legislative agenda; second, consider how Mr. Trump's and the House Blueprint for tax reform address repeal; third, discuss the legislative process and the "permanence" of any legislation; fourth, consider why it is important to continue to plan and consider current plan designs; and finally, briefly address the cost of delay (saving the heavy lifting regarding the cost of delay for Part II of this newsletter).

Trump's Big Agenda and the Legislative Process

President-Elect Trump has outlined a huge agenda:

1. Repeal Obama Care/Health Care Reform
2. Infrastructure
3. Immigration Reform
4. Tax Reform
 - a. Personal
 - b. Business
 - c. Estate Tax Repeal

Successful implementation of just one of these items would be an administration-defining legacy. On the other hand, any one could become a quagmire resulting in nothing getting done. Most create substantial federal deficits. Infrastructure carries an estimated \$1 trillion price tag, and many feel that number is low. Immigration is a hugely contentious topic and implementation could carry a substantial price tag. Consider attempts to reform health care in the past. Secretary Clinton, then First Lady, could not get it done during the Clinton Administration, and it took major efforts by the Obama Administration. AALU (Association for Advanced Life Underwriting) has posited that doctors, hospitals and health insurance companies who have spent hundreds of millions of dollars complying with Obamacare will be reluctant to support a new system requiring significant time and expense to comply.ⁱⁱ

It remains to be seen how these agenda items will be prioritized. Obamacare is allegedly number one. But priorities change. Tax reform may be moved to the head of the list. The republican Congress, with a slight majority of 51 senators, would have to be fully aligned but even then, there are significant hurdles to overcome. Congress may or may not be successful in passing reform during the new administration's seven to eight month honeymoon period or it could be years before we know the outcome.

Transfer Tax Reform Proposals

There are two proposals on the table for transfer tax reform,ⁱⁱⁱ Mr. Trump's Plan and the Tax Reform Task Force of the House Ways and Means Committee plan (referred to as the "House Blueprint").^{iv} Both plans primarily emphasize income tax reform, but include transfer tax repeal. Mr. Trump proposes to eliminate the gift and estate taxes (the GST tax is not mentioned, but presumably that would be repealed as well), and may introduce a capital gain tax on death. It is not clear whether Trump's plan would also introduce a capital gain on gifts or continue the carryover basis on gifted assets.

In two very brief paragraphs (out of a 35 page document), the House Blueprint proposes eliminating estate and GST taxes (gift taxes are not mentioned). This proposal does not address stepped up basis. Presumably if all three transfer taxes are repealed, stepped-up basis would be replaced by carry-over basis.

Legislative Paths to Repeal

Congress has two possible paths to enact tax reform. The first, traditional legislation, would be introduced by the House Ways and Means Committee and would ultimately be subject to a filibuster requiring 60 votes in the Senate to enact reform, making this path unlikely.

The second, budget reconciliation requires only 51 votes in the Senate to pass and is not subject to filibuster. Two comments are in order. First, AALU reports that many Republican lawmakers feel that the estate tax was addressed when the exemption was raised to \$5M.^v In other words, the Republicans are divided and may not unanimously vote for reform. Second, the Byrd Rule requires that in order for legislation to become "permanent", revenue deficits created in the second 10-years of the proposed legislation (the "out-years") must be offset by spending cuts.^{vi} The Tax Policy Center estimates the revenue loss due to tax reform in the out-years 2027-2036 for the two proposals as follows:

- House Blueprint. \$2.2 trillion
- Trump proposal. \$8.9 trillion.^{vii}

If Republicans cannot find the required spending cuts to offset deficits in the out-years, then repeal would only be for ten years. We saw this in 2001 when estate tax reform increased the exemption each year from 2001 to 2009, repealed the estate tax for 2010 only (while retaining the gift tax)^{viii} and, in 2011, reverted to the law in effect prior to 2001.

But even if "permanent" repeal is enacted, as soon as the Democrats are back in power they will likely implement higher taxes in one form or another. And so we will seesaw into the future as the balance of power tips back and forth between the two parties. All a great waste of time for a set of laws that are well established, cohesive, and affect a miniscule portion of the population.

To summarize:

1. Is repeal likely?
 - A. Due to the magnitude of Trump's agenda and depending upon the priority of agenda items, we could see tax reform legislation in the first months of the Trump administration or it could be years.
 - B. Traditional legislation would be subject to filibuster which requires 60 votes in the Senate to enact tax reform, an unlikely scenario.
 - C. Republicans appear divided so it may not be able to obtain the 51 vote majority for repeal under reconciliation.

2. If passed, will repeal be permanent?

- A. If tax reform/repeal legislation is unable to generate spending cuts to offset deficits, then any repeal would be for ten years only, after which we would revert to our current laws.
- B. Even if “permanent” repeal was passed, as soon as Democrats have sufficient control, the transfer and/or income taxes are likely to be increased.
- C. The only truly permanent repeal would be by a constitutional amendment.^{ix}

Possible Outcomes

A few of the possible outcomes are as follows (subject to a 10-year or “permanent” duration as discussed above):

	Gift	Estate	GST	Stepped-Up Basis
1	Not Repealed	Not Repealed	Not Repealed	Not Repealed
2	Not Repealed	Repealed	Repealed	Repealed
3	Repealed	Repealed	Repealed	Repealed
4	Repealed	Repealed	Repealed	Not Repealed

Note: Mr. Trump’s plan has proposed realization of built in gains on death. It is not clear whether Trump’s plan would also introduce a capital gain on gifts or continue the carryover basis on gifted assets.

Planning Going Forward

With all of this uncertainty, what is a logical way forward in advising our clients? I believe the following:

- It is essential to continue to plan today and implement wealth transfer strategies.
- Living with uncertainty regarding transfer taxes (including a possible capital-gain-on-death tax) could become the new normal.
- This uncertainty will make us all better planners, resulting in superior advice for our clients.
- Whereas in the past, we planned strictly based on the law as it stands at that time, now we have to adjust and broaden our thinking.
- A critical component will be introducing greater flexibility into our planning. This might include springing (and un-springing) distribution powers, trust protectors, greater use of decanting as well as dual spousal lifetime access trusts and beneficiary defective inheritor trusts.

In the interest of opening a dialogue, the following is a reasonable approach to planning currently for high net worth and ultra-high net worth clients; especially considering the cost of delay addressed in Part II of this newsletter:

Note: The following assumes that defective grantor trust rules remain in effect.

1. Clients should continue to plan utilizing transfers to dynasty trusts that are defective grantor trusts. In order to take advantage of planning opportunities that may present themselves under possible new laws, it will be important to retain flexibility with the ability to unwind a transaction:
 - A. Swap powers will be useful (except in the case of a BDIT) should it become advantageous to move specific assets in or out of trust.
 - B. Site trusts in a state with favorable decanting, income tax, rule against perpetuities laws such as Nevada or South Dakota.
 - C. Utilize trust structures that provide ongoing access to transferred funds:
 - i. For married couples, dual spousal access trusts (taking care to avoid reciprocal trusts).
 - ii. For a single client or married couples who desire greater control, beneficiary defective inheritor's trust (BDIT).
 - iii. Consider the use of independent trustee(s) with absolute discretion regarding distributions, giving the client and ultimately beneficiaries removal/replacement powers (subject to Code §672(c)).
 - iv. Consider trust protectors or a new trust position to turn powers on and off.
 - v. Utilize special powers-of-appointment.
2. Until such time as new legislation repeals the gift tax, continue to make discounted gifts using annual exclusion gifts and remaining gift and GST exemptions.
 - A. If the gift tax remains in effect, if repeal is for 10-years only then reverts to current law, or if no changes to current law, it's a win as planning has always been.
 - B. If the gift tax has been repealed along with estate and GST taxes, then presumably these gifted assets in trust would avoid Trump's capital gains on gift or upon death (assuming that became law).
 - C. If the Democrats ultimately i) reinstate current law, it's a win as planning has always been; or ii) implement a new tax regime, the plan should be flexible enough to take advantage of new opportunities.
 - D. If the new proposal includes carryover basis on lifetime transfers, the current gifts will have done no harm and, in fact, would have done much good considering all of the non-tax reasons for planning.
3. Regardless the repeal outcome (ranging from no repeal to full repeal), consider the following strategies that, if properly valued, do not include gifts and will continue to make sense until some aspect of new legislation indicates otherwise:
 - A. Discounted sales to defective grantor trusts. Provided that the sold assets are valued properly, there is no gift. Parties may want to consider taking a more conservative valuation approach.
 - B. Intra-family loans at favorable AFRs should continue to be utilized.
 - C. Life insurance should be part of every current planning dialogue. It provides an income tax-free death benefit and strong wealth transfer characteristics in all repeal scenarios acting as a perfect hedge against the uncertainty. Evaluate economic benefit and loan regime split dollar funding designs.
 - D. Again, employ strategies that provide the ability to adjust or unwind the transaction.

4. The most challenging scenario is the one that is the least likely: repeal of all transfer taxes, retention of stepped-up basis upon death, and truly permanent repeal. In that case, has the planning been a waste? The clients and their families benefit from all of the non-tax reasons for planning, and have implemented a hedge against the more likely scenarios.
5. For high net worth clients who live in decoupled states, there are substantial estate taxes to be saved as a result of lifetime transfers. With the repeal of the federal estate tax, the state estate taxes would no longer be deductible against the federal. With most states in need of tax revenues, it seems unlikely that these remaining states will repeal their estate tax and other states might enact new estate taxes.

The Cost of Delay

The cost of delaying planning can be substantial.^x Strategies such as gifts and/or sales to defective grantor trusts take time to move appreciation out of the estate. In addition, it is important to lock in favorable rates today since over time AFRs may increase, gift and GST exemptions may be reduced, and discounts may no longer be available or greatly reduced. Even if all planning factors remain the same, based on very conservative assumptions, the reduction in the amount wealth transferred is substantial.

Delaying the purchase of life insurance can result in substantially greater costs or it may be unavailable:

- Declines in health may have rendered one or both spouses rated or uninsurable.
- One spouse may have passed away.
- Even if the clients' health remains the same (for example, still qualify for preferred rates) or they have locked in insurability with term insurance with strong conversion options, a 10-year purchasing delay will result in substantially greater costs to fund or clients will only be able to purchase far less insurance.
- Today's favorable products may no longer be available, for example, no lapse guaranteed UL may no longer be available.

In closing, let's look at this as an opportunity to continue to truly serve our clients and their families' planning needs, and in fact become better planners in the process.

Hope this helps you help others make a positive difference!

Bob Finnegan

CITATIONS:

- i. As of 12/08/2016, there are 51 republican senators, but the number could increase to 53. Louisiana has two runoffs scheduled for December 10th, one of which could add one more republican, and if Mr. Trump nominates Senator Heidi Heitkamp (R-North Dakota) to run the Agriculture Department, the republican governor will likely appoint a republican replacement.
- ii. AALU “White House Transition Webinar” (November 16th, 2016)
- iii. Based on the author’s discussion with an AALU staff attorney, it is unlikely for transfer tax repeal to be addressed separately from overall tax reform. Congress will get one shot at overall tax reform. (November 22, 2016)
- iv. “A Better Way: Our Vision for a Confident America” (June 24, 2016), Tax Reform Task Force of the House Ways & Means Committee, i.e. the House Blueprint.
- v. A recent AALU article states, “Privately many Republicans would prefer not to waste political and policy capital on an issue that largely has been solved”. AALU “Estate Tax: What to Tell Your Clients About the Estate Tax”, (November 22, 2016). An excellent piece that provides insight into the partisan politics that could affect the outcome.
- vi. See “Introduction to Budget ‘Reconciliation’” (Updated November 9, 2016), Center on Budget and Policy Priorities. <http://www.cbpp.org/research/federal-budget/introduction-to-budget-reconciliation>
- vii. Urban Institute and Brookings Institute of the Tax Policy Center Research Reports:
 - a. “An Analysis of the Donald Trump’s Revised Tax Plan” (October 18, 2016), <http://www.taxpolicycenter.org/publications/analysis-donald-trumps-revised-tax-plan>. Trump’s plan also increases interest costs in the “out-years” by \$4.7 trillion.
 - b. “An Analysis of the House GOP Tax Plan” (September 16, 2016), <http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full>. The House Blueprint increases interest costs in the “out-years” by \$2.0 trillion.
- viii. Economic Growth and Tax Relief Reconciliation Act of 2001 (June 7, 2001).
- ix. A Constitutional amendment would require both houses of Congress to pass a call for an amendment repealing the estate tax. Following a joint resolution supported by two-thirds of both the Senate and the House, three-quarters of the states would need to ratify the amendment in order for it to become law.
- x. Based upon a modeling approach, Part II of this Newsletter will quantify the reduction in wealth transferred to heirs as a result of delaying planning for 10-years. It will evaluate planning currently versus 10-years based on a reasonable set of assumptions, with and without life insurance for a likely repeal scenario.

