Fulcrum Partners LLC, (fulcrumpartnersllc.com) is one of the nation's largest executive benefits consultancies. A wholly independent, member-owned firm, Fulcrum Partners is dedicated to helping organizations enhance their Total Rewards Strategy. Founded in 2007, today the company has 13 nationwide offices and more than $7B in assets under management.

Fulcrum Partners is pleased to share the following insights from AALU.

Highlights from the 54th Annual Heckerling Institute on Estate Planning

The WRMarketplace is created exclusively for AALU members by experts at Baker Hostetler LLP and the AALU staff, led by **Jonathan M. Forster, Partner, Rebecca S. Manicone, Partner, and Carmela T. Montesano, Partne**r. WR Marketplace #20-04 was written by **Michael P. Vito, Counsel, and Lindsay R. DeMoss D'Andrea, Staff Attorney, Baker & Hostetler LLP.**

The AALU WR Newswire and WR Marketplace are published by the AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

Thursday, February 20, 2020 WRM#20-04

TOPIC: Highlights from the 54th Annual Heckerling Institute on Estate Planning

MARKET TREND: Modern strategies for legacy planning with today's clients were the focus of discussions at the 2020 Heckerling Institute on Estate Planning.

SYNOPSIS: The 54th Annual Heckerling Institute on Estate Planning (the "Institute") focused on the ongoing effects of the Tax Cuts and Jobs Act ("TCJA"), including: (1) legal and regulatory developments concerning life insurance; (2) benefits and burdens of grantor and non-grantor trust status; (3) planning considerations for migratory clients; (4) state income taxation; (5) implications of the SECURE Act; and (6) planning for the generation-skipping transfer ("GST") tax on nonexempt trusts.

TAKE AWAY: The Institute covered a variety of creative and contemporary techniques tailored to meet the needs of a broad range of clients. Given the complexity of IRS rules and an everchanging legislative landscape, clients and advisors should build flexibility into client planning where possible. All legacy plans will continue to require diligent monitoring and review to ensure that the plan will continue to accomplish the client's goals under current and evolving law.

Below are curated insights from the Institute reflecting notable legacy planning developments and strategies:

Legal and Regulatory Insurance Developments. As part of a continued focus on life insurance, this year's presentations reviewed recent legal and regulatory developments, including generational split-dollar arrangement litigation under *Estate of Morrissette v. Commissioner*,[i] and a set of Private Letter Rulings ("**PLRs**") regarding the reformation of an irrevocable life insurance trust ("**ILIT**").

- Generational Split-Dollar Arrangements: *Morrissette*. As discussed in *WRMarketplace Nos. 18-26* and *19-21*, *Morrissette* is a case involving economic benefit generational split-dollar arrangements ("**EB GSDs**"). Generally, EB GSDs involve a split-dollar arrangement between a parent and his or her ILIT to fund the trust's purchase of life insurance on the life of his or her child. For wealth transfer planning purposes, EB GSDs assume that the present value of the repayment owed to the parent for his or her payment of the policy

premiums is subject to a significant discount upon transfer due to the extended repayment period (i.e., based on the insured child's life).

The Tax Court's prior summary judgment opinion in *Morrissette* declined to uphold the applicability of a discount on the repayment right as a matter of law. *Morrissette* continues to progress: trial was held the week of October 7, 2019, briefs were due by January 21, 2020, and reply briefs are due by March 9, 2020.

WHY IT MATTERS: While the case is pending, clients and advisors should take this opportunity to review any existing EB GSDs and consider possible courses of action that can be implemented promptly after any final Tax Court decision, including whether the structure could or should be modified.

- PLRs Regarding Reformation of ILIT. In PLRs 201919002 and 201919003, a grantor established an ILIT for the benefit of the grantor's child and the child's descendants, naming the child as trustee. The child possessed a testamentary limited power to appoint the trust assets among the child's descendants. The child could appoint, remove, and replace trustees, and appoint a special co-trustee if the trust ever owned or otherwise possessed any incidents of ownership over any life insurance policies on the life of the child within the meaning of Internal Revenue Code ("Code") § 2042. The child was concerned that the limited power of appointment and the child's powers as trustee could cause proceeds of any life insurance owned on the child's life to be included in the child's gross estate for federal estate tax purposes. The child obtained a court order reforming the trust to: (1) remove the testamentary limited power of appointment with respect to any life insurance policy on the child's life or its proceeds; (2) add an Insurance Trustee with sole authority over any insurance policies on the child's life purchased by the ILIT; and (3) require that premium payments on life insurance policies on the child be paid out of trust principal, not income. The child's sibling was appointed as Insurance Trustee and given all of the incidents of ownership with respect to the policy insuring the life of the child. The child held a power to remove and replace the Insurance Trustee; however, the child could not appoint any person related to or subordinate to the child within the meaning of Code § 672(c). The IRS privately ruled that the reformation of the ILIT successfully eliminated incidents of ownership over any such life insurance policy, and that the proceeds of any such policy would not be includible in the child's gross estate under Code § 2042(2).

  WHY IT MATTERS: PLRs 20191902 and 201919003 seemingly apply the principles stated in Rev. Rul. 95-58, where the IRS ruled that a trustee's powers would not be imputed to a grantor under Code §§ 2036 or 2038 if the grantor had the unrestricted right to remove and replace a trustee, as long as the successor was not related or subordinate to the

grantor within the meaning of Code § 672(c). While PLRs in general have no precedential value, the result here is a reasonable extension of Rev. Rul. 95-58 and tacitly confirms a recognition by the IRS that, for estate inclusion purposes, the rules regarding the determination of whether an individual holds incidents of ownership in a life insurance policy under Code § 2042 should be interpreted in a manner similar to the rules under Code §§ 2036 and 2038 regarding the determination of whether an individual has retained certain rights to enjoy or control previously transferred property.[ii]

Grantor vs. Non-Grantor Trust Status. Several Institute sessions focused on the choice between grantor and non-grantor trust status and considered non-conventional uses of these familiar tools[iii].

Non-Grantor Trusts. Generally, a trust is a non-grantor trust and treated as a separate taxpayer for federal income tax purposes by default. The income liability is computed under a compressed rate table that quickly applies the highest tax rate. Non-grantor trusts benefit from deductions, including trustee commissions and certain other administration expenses, state and local taxes, and charitable contributions. Most importantly, non-grantor trusts also receive a deduction for distributions to beneficiaries. The effect of this deduction effectively passes the income tax obligation to the beneficiaries in proportion to their distributions. Some creative ways to use non-grantor trusts include:

- Use of Trust Assets. As noted above, distributions from a non-grantor trust can carry out taxable income to the beneficiary receiving the distribution. While the trust obtains a deduction for distributions made to the beneficiary, the beneficiary must take into gross income a portion of his or her distributions as reported by the trustee. When a beneficiary is located in a high income tax state, this result can be particularly harsh. Instead, if permitted by the governing instrument, the trustee could grant the beneficiary use of trust assets, such as a residence or tangible property. With the exception of property held in foreign trusts, such use of trust assets should not be deemed a constructive distribution from the trust, and thus, should not carry out any taxable income to the beneficiary[iv].
- Charitable Deductions. Under Code § 642(c), a non-grantor trust can qualify for an unlimited income tax deduction for distributions to charity made pursuant to the trust instrument. However, clients may be uncomfortable naming a specific charitable beneficiary or listing a particular amount at the time the trust is created. To ease that discomfort and maintain the opportunity, the client could instead grant an individual a lifetime limited power to appoint gross income to a charitable beneficiary. The IRS has ruled that income paid to charity pursuant to a lifetime limited power of appointment

satisfies the requirement under Code § 642(c) that the income must be paid pursuant to the provisions of the trust instrument[v]. Such a power ideally should permit appointments to charity specifically, rather than including a broad class of permissible appointees that would be interpreted as including charities (e.g., allow appointment to the narrow class of "qualified charities," rather than to the broad class of "any persons")[vi].

WHY IT MATTERS: The post-TCJA environment has created increased interest in non-grantor trusts, as the separate deductions available to a non-grantor trust can, in the right circumstances, result in less cumulative tax imposed on the grantor's individually owned assets and the assets held in non-grantor trust. Non-grantor trusts may provide further opportunities for state income tax planning where certain distributions and elections could reduce the total income carried out to beneficiaries. Non-grantor trusts also can provide flexibility in charitable planning, since they are not subject to income percentage itemized deduction limitations in the same way as individuals. Accordingly, clients may want to consider including lifetime limited powers of appointment exercisable in favor of charities in future non-grantor trust instruments.

Grantor Trusts. Grantor trusts are not treated as separate taxpayers[vii]. Instead, the income of a grantor trust is taxed to the grantor (often the trust creator) because he or she has retained one or more powers over the trust. A trust also may be a "grantor trust" with respect to someone other than the trust creator (e.g., a beneficiary) if that person possesses certain interests in the trust.

With a grantor trust, a grantor's (or other deemed owner's) payment of the income tax liability is not a gift for gift tax purposes, since the tax liability is that individual's legal responsibility. In addition, the grantor may be given the ability to substitute low-basis assets out of the trust without triggering a tax and may otherwise transact with the trust without recognizing the transaction for income tax purposes[viii]. Balancing these features is the fact that the trust grantor or deemed owner must report and pay tax on the trust's income at his or her personal income tax rates, even though he or she may not receive any offsetting benefits from the trust.

The Institute presented modern uses of beneficiary-owned trusts as grantor trusts, including Beneficiary Deemed Owner Trusts ("**BDOTs**") and Beneficiary Defective Inheritor's Trusts ("**BDITs**")[ix].

- BDOTs. Under Code § 678(a)(1), a person other than the grantor is considered the owner of all or a portion of trust property when that person has a power solely exercisable by

himself to vest the trust principal or the income therefrom in himself. Code § 678(a)(1) requires simply that the beneficiary hold the requisite power in order to be the deemed owner, not that the power be exercised. Thus, while the BDOT would grant the beneficiary a power to withdraw trust income or principal, the beneficiary does not need to actually exercise the power to trigger grantor trust status with regard to himself or herself under Code § 678(a)(1)[x].

- BDITs. Under Code § 678(a)(2), a person other than the grantor is considered the owner of any portion of a trust over which the person: (1) partially released or otherwise modified a power to vest trust principal in himself or herself described under Code § 678(a)(1); and (2) retains control that would cause the grantor to be the deemed owner. Thus, when a trust is not a grantor trust as to the trust creator, and a beneficiary has a power to withdraw contributions to the trust, the beneficiary is the deemed owner of the trust both while the withdrawal power is exercisable and after the power is partially released (i.e. not exercised or allowed to lapse)[xi]. Lapsed or released withdrawal powers cause estate and gift tax concerns, however, since a lapse of a withdrawal power is treated as a release of a power for gift tax purposes under Code §§ 20211 and 2514. A released power causes the released portion to be includible in the beneficiary's estate for estate tax purposes. For this reason, transfers to BDITs typically do not exceed $5,000 so that a lapsed power qualifies for exceptions to this estate inclusion rule[xii]. BDOTs are generally more flexible than BDITs, since contributions to a BDOT can exceed $5,000 without this risk.

  These types of trusts have several advantages. The use of a BDOT or BDIT can potentially result in a lower effective income tax rate without mandatory distributions from the trust. The beneficiary-grantor must pay the income taxes for the trust, which enhances compounding growth within the trust. Additionally, like a traditional grantor trust, the beneficiary can transact with the BDOT or BDIT without recognizing the transaction for income tax purposes.

  WHY IT MATTERS: Grantor trusts have played a critical role in legacy planning with life insurance. Modern uses of grantor trusts – such as with a BDOT or BDIT – can create additional legacy planning opportunities where the parties are looking for creative and flexible strategies. However, clients and advisors must exercise caution. Mastery of the arcane grantor trust rules is a prerequisite, and the IRS has expressed hostility to such techniques, particularly in the context of asset sales involving such trusts[xiii].

  Planning Considerations for Migratory Clients. Several presentations focused on migratory clients and the impact of state residency[xiv]. Today's clients are increasingly mobile, with families spread across the country and abroad, and property located in

multiple jurisdictions. When a client is deciding where to move, he or she must consider the legal effects of residency, possibly in more than one jurisdiction, including state taxation, qualification for government assistance (such as for dependent family members or beneficiaries), and access to education or other resources. Highlights in this area from the Institute include:

- State Trust Taxation. State fiduciary income tax rates applicable to non-grantor trusts vary, from no income tax to a tax rate of over 13%. While each jurisdiction has its own rules for determining whether a trust is subject to tax, the statutes typically look to the following factors: (1) residence of the grantor when the trust was created, funded, or became irrevocable; (2) location of the beneficiaries; (3) location of the trustees; and/or (4) location of the trust's administration.
- *Kaestner.* State income taxation of non-grantor trusts has continued to be a topic of significant interest at the Institute, particularly in light of the Supreme Court's decision in *North Carolina Department of Revenue v. The Kimberly Rice Kaestner 1992 Family Trust*[xv]. As discussed in *WRMarketplace No. 19-13*, the U.S. Supreme Court unanimously held that in-state residence of trust beneficiaries did not provide the minimum connection with North Carolina necessary to support its taxation of trust income where no distributions were made from the trust. The Court's holding in *Kaestner*, while limited to the facts of that case, underscores the importance of anticipating the impact of state income taxes on migratory clients.
- Incomplete Gift Non-Grantor Trusts. Several sessions at the Institute included a review of Incomplete Gift Non-Grantor Trusts ("**INGs**")[xvi]. An ING is a self-settled, irrevocable, asset-protection trust for the benefit of the grantor and other beneficiaries. The trust is most often settled in a state that does not impose state income or capital gains tax on resident trusts. As a non-grantor trust, the trust income is not taxable to the grantor and thus, also not subject to state income tax in the grantor's state of domicile; however, the trust income remains taxable to the trust for federal income tax purposes. The transfer to the ING by the grantor is designed as an incomplete gift for transfer tax purposes, which means the assets remain includible in the grantor's estate. As a result: (1) the grantor's federal gift and estate tax exemption is unaffected at the time of the transfer; and (2) the trust assets are eligible to receive a step-up in basis upon the grantor's passing. Depending on the jurisdiction, varying levels of creditor protection may be achieved for the grantor and his or her family. Note, however, that a client must give up significant control for an ING to be effective.

WHY IT MATTERS: The residency of a client typically governs the rules relating to inheritance, divorce, entitlement to certain public benefits, and personal tax consequences. A change in the residency of a trustee, grantor, or beneficiary may

unintentionally subject a trust to income tax in the new jurisdiction. However, with proactive planning – such as with an ING – clients may be able to better control these factors.

The SECURE Act. A special session focused on the SECURE Act (the "**Act**") and its effects on retirement planning[xvii]. As discussed in *WRMarketplace No. 20-02*, the Act contains several significant changes, including: (1) a 10-year payout requirement for qualified retirement plans (e.g., traditional IRAs, Roth IRAs, and 401(k) and 403(b) plans) inherited by most non-spouse beneficiaries; (2) no maximum age restrictions on contributions to a traditional IRA; (3) increased age at which required minimum distributions are triggered (from 70 ½ to 72 years old); (4) new lifetime income and annuity product offerings inside qualified plans; (5) penalty-free withdrawals up to $5,000 following the birth or adoption of a child; and (6) expanded access to qualified retirement plans for small businesses and part-time employees.

WHY IT MATTERS: Under the Act, legacy plans incorporating the prior concepts of "stretch IRAs" and "conduit trusts" may no longer accomplish the client's intended goals. Still, other approaches such as Roth IRA conversions, accumulation trusts, charitable remainder trusts, and irrevocable life insurance trusts may serve as viable alternatives. New tax credits and incentives also may increase the number of small businesses that offer qualified retirement plans to employees.

Planning for the GST Tax on Nonexempt Trusts. Another focus from the Institute was planning for the GST tax[xviii]. The GST tax presently applies at a flat 40% rate to "taxable terminations" and "taxable distributions" from certain trusts passing to grandchildren or more remote beneficiaries. For example, if a client establishes an irrevocable trust for the benefit of his children and grandchildren that is not fully exempt from GST tax, a taxable termination will occur upon the passing of the last surviving child (a "nonskip" person) since all remaining interests in the trust will then be held by grandchildren ("skip persons"). Similarly, any distribution from such a nonexempt trust to a grandchild during the lives of the children would be subject to the GST tax as a taxable distribution. Panelists suggested several strategies to plan for such GST taxable events, including:

- Distributions to Nonskip Persons. One of the simplest mechanisms for ameliorating the impact of the GST tax on a nonexempt trust is to make distributions to nonskip persons before a taxable termination occurs. Depending on the governing instrument, distributions may be made in the discretion of the trustee or pursuant to limited powers of appointment. Such distributions can then allow nonskip beneficiaries to facilitate their own legacy planning goals.

- Late Allocations. Generally, an individual's GST exemption must be allocated to transfers made in trust on a timely filed gift tax return filed for the year of transfer. However, Treasury Regulations also permit the late allocation of GST exemption to such a transfer in certain situations. Thus, while making a timely allocation is preferable, a late allocation can be one way to address GST tax concerns if an initial allocation was missed, if circumstances have changed, or if the client has excess GST exemption that he or she does not intend to use in other planning. However, the rules relating to late allocations present procedural challenges and must be followed precisely in order to achieve the desired result.

WHY IT MATTERS: As clients and families continue to accumulate and grow their wealth, they are more likely to have trusts that are subject to the GST tax. With careful planning, the GST tax potentially may be postponed or avoided, and clients and their advisors should evaluate appropriate solutions.

TAKE AWAY: The Institute covered a variety of creative and contemporary techniques tailored to meet the needs of a broad range of clients. Given the complexity of IRS rules and an everchanging legislative landscape, clients and advisors should build flexibility into client planning where possible. All legacy plans will continue to require diligent monitoring and review to ensure that the plan will continue to accomplish the client's goals under current and evolving law.

NOTES

[i] U.S. Tax Court Docket No. 004415-14, Order and Decision dated June 29, 2018.

[ii] For a more detailed discussion of these insights, see materials prepared by Steve R. Akers, Turney P. Berry, Samuel A. Donaldson, Charles D. "Skip" Fox, IV, Jeffrey N. Pennell, Charles A. "Clary" Redd, and Howard M. Zaritsky (edited by Ronald D. Aucutt) for "Recent Developments 2019" as presented by Steve R. Akers, Turney P. Berry, and Carol A. Harrington on January 13, 2020 at the 54th Annual Heckerling Institute on Estate Planning.

[iii] For a more detailed discussion of the uses of grantor and non-grantor trusts, see materials prepared by Austin Bramwell, S. Stacy Eastland, Carlyn S. McCaffrey, and Edwin P. Morrow, III for "Creative Planning Techniques with Grantor and Non-Grantor Trusts" as presented by Austin Bramwell, S. Stacy Eastland, Carlyn S. McCaffrey, and Edwin P. Morrow, III on January 15, 2020 at the 54th Annual Heckerling Institute on Estate Planning; see also materials prepared by Austin Bramwell, S. Stacy Eastland, Carlyn S. McCaffrey, and Edwin P. Morrow, III for "Beyond the Binary: Choosing Between Grantor and Non-Grantor Status" as presented by Austin Bramwell and Carlyn S. McCaffrey on January 15, 2020 at the 54th Annual Heckerling Institute on Estate Planning.

[iv] See id. Note that the result would be different with respect to property held in a foreign trust.

[v] IRS G.C.M. 34277 (1970); see Bramwell, et al., "Creative Planning Techniques with Grantor and Non-Grantor Trusts," supra Note 5, at 141.
[vi] See Bramwell, et al., "Creative Planning Techniques with Grantor and Non-Grantor Trusts," supra Note 5, at 140.
[vii] A trust is only a grantor trust when one of the "grantor trust rules" under Code §§ 671-679 applies.
[viii] For a more detailed discussion of grantor trusts, see materials prepared by Samuel A. Donaldson for "The Life-Changing Magic of Grantor Trusts" as presented by Samuel A. Donaldson on January 13, 2020 at the 54th Annual Heckerling Institute on Estate Planning.
[ix] See WRMarketplace No. 15-32 for a discussion the basics of BDITs.
[x] For a complete discussion of these techniques, including risks, benefits, and other considerations, see Bramwell, et al., "Creative Planning Techniques with Grantor and Non-Grantor Trusts," supra Note 5, at 80.
[xi] See id., at 99.
[xii] See Code §§ 2041(b)(2) and 2514(e).
[xiii] See id., at 80.
[xiv]See materials prepared by Jonathan G. Blattmachr, G. Michelle Ferriera, and Diana S.C. Zeydel for "Peripatetic Clients: No, It's Not an Illness, But They Need Your Constant Care" as presented by Jonathan G. Blattmachr on January 14, 2020 at the 54th Annual Heckerling Institute on Estate Planning; see also materials prepared by Jonathan G. Blattmachr, G. Michelle Ferriera, and Diana S.C. Zeydel for "Have You Successfully Crossed States Lines or Have You Lost Your Way?" as presented by Jonathan G. Blattmachr, G. Michelle Ferriera, and Diana S.C. Zeydel on January 15, 2020 at the 54th Annual Heckerling Institute on Estate Planning.
[xv] 139 S. Ct. 2213 (2019).
[xvi] See WRMarketplaces Nos. 16-36 and 17-05 for an overview and discussion of ING trusts.
[xvii] For additional details and discussion, see materials prepared by Natalie B. Choate for "Planning for Retirement Benefits After the SECURE Act" as presented by Natalie B. Choate on January 16, 2020 at the 54th Annual Heckerling Institute on Estate Planning.
[xviii] See materials prepared by M. Read Moore, John P. Edgar, and Jeanette Suarez Hunter for "A Sequel Much Worse Than the Original: Planning for GST Tax on Nonexempt Trusts," presented by M. Read Moore, John P. Edgar, and Jeanette Suarez Hunter on January 16, 2020 at the 54th Annual Heckerling Institute on Estate Planning.