Audio file

KN9 - Ashley Sawyer.wpp.m4a

Transcript

Hello and welcome to the Newton Knowledge podcast. My name is Mark Singer, partner in Newton Advisors. And today I'm joined by my colleague Stephen Target, managing partner of our firm, Steve. How are you today?

Doing great mark. Thanks for.

Asking the Neat Knowledge Podcast will prove meaningful content to our valued advisor, community and clients who are interested in learning more about sophisticated insurance related topics focused on estate planning and executive benefits. During our podcast, we focus our discussions on content that will deliver unique risks into the people, processes and products that make our industry so critical. Week 1 is a national life insurance planning firm delivering customized insurance solutions structured to help clients and their advisors engage in solving the state planning wealth transfer, business succession and executive benefits challenges. We are a member of the Financial Group offering our clients access to the nations most prestigious insurance carriers and innovative products available only through our network. Today, we have the privilege in speaking with Ashley Sawyer, our partner at Logan Loeb. Ashley focuses her practice on tax efficient planning for wealthy individuals, families and business executives. She advises on legacy. Planning for younger generations, estate, gift and generation skipping techniques. She also counsels exempt organizations, including charitable trust, private foundations, public charities on matters involving tax exempt status and navigating governance issues. Ashley has been recognized as the ones to watch list for the best lawyers and trusting states for this year. She has planned many publications, but the one that caught our eye really initiated today's engagement. Was the peace in December that she co-authored with Mary Ann Manson, who was also a partner global mode titled Life Insurance Mistakes that Keep Attorneys up at Night. This was distributed via within second the nations leading financial securities professional lobbyist group, bringing together resources and traditions of. Boomer ACLU and gain international membership organizations with nearly 6000 members advocating on behalf of life insurance and retirement planning solutions that protect the dreams and promote the prosperity of the American people. So to no further ado, Ashley, thank you for being here today. Welcome. And how are you?

Thank you for having me. I'm very happy to be here. I'm doing very well. Thank you. I'm very excited about this opportunity to speak with you all today and I look forward to our.

Fantastic. We're happy to have you here.

Mark, thank you and again thank you to Ashley Sawyer and Marianne Mancini and a a big thank you to Finn Seka for making this introduction and publishing the article. You know, I think I'm going to frame today's conversation by just simply stating that 20/21 was a strange and difficult year for planning due to the proposed build back better legislation. Which impacted a lot of the life insurance and estate planning that had been implemented. Previously or was proposed to be implemented for families, so. As we think. About it potential changes to grantor trusts the federal state tax exemptions and other things made it very difficult to make decisions regarding planning regular conversations. As we all know, occurred

between all professional advisors. Regarding the need to implement plans immediately with the hopes of being grandfathered, or rather the wait and see approach, depending upon what the thoughts were regarding the legislation and none of US advisers and clients alike, like to make these types of decisions in a time frame that's too short and pressured. So today's conversation is going to address some of the mistakes that could have been made if the advisors moved too quickly without considering what the potential consequences were of those planning decisions. And we're going to jump right into it here with the mistakes that trigger and gift taxes and Ashley, the article begins with the discussion around mistakes that potentially could. Could trigger gift taxes and you. Turns such important items as the changes to grant or child, or naming individuals versus multiple owners, and even the misunderstood topic. I would say it's misunderstood of naming different owners, different insurers and different beneficiaries and so could you speak to a couple of the mistakes and potential ways to avoid those mistakes?

Sure, sure. Absolutely. Thank you. And and you're very right, the the changes that came about particularly at the end of the year. Triggered a number of people's clients and advisors alike to have a knee jerk reaction. How do we avoid the issues that these proposed regulations, particularly with respect to the grantor trust rules we'll have if we don't act quickly because as The Reg said or the proposed legislation said? The effective date would be the date of enactment, so we wouldn't necessarily have much time to address these these potential issues. Would arise. So yeah, the last couple of years. Like you said. Have have been unique and difficult for a variety of reasons, but our focus was really on how a state and tax planning was going to be affected for people living life insurance was involved. The tax proposal that I'll talk about right now was the changes to the grantor trust rules, which would create a situation where. Best assets that were intended to be exempt from estate tax would lean back into the Grantors estate and be taxable at the. So really just mitigating the benefits of our planning in the case of life insurance trusts or Iowa flow for the pilots, which traditionally have been used to keep policies in the death benefit outside of the grantors taxable state under these proposed regulations, presumably each time the contribution is made to an islet to pay premiums. Which really is how pilots traditionally are set up. They just hold the life insurance policy and then crummy gifts or annual exclusion gifts are used to pay those premiums each year. There are other ways their loans with dollar loans. Things like that that people. Used but the primary way of funding these premiums traditionally has been using annual exclusion gifts, which means there's a contribution each year. So presumably each time a contribution is made to an islet to pay premiums under these new regulations, a portion of the overall trust assets would become includable in the grant towards the state. Consequently. When the insured passes and the death benefit on the policy is paid to the trust, which is much larger than what the trust assets were at the time the contribution was made, the problem in the state inclusion increases exponentially now because that includable percentage of the trust is now a percentage of a multi $1,000,000 policy. So it really scared the insurance industry quite a bit. There were a number of articles that came out similar to ours, a number of webinars, things like that that we're trying. To educate people and what? Could happen under these proposed regulations, or actually they haven't been passed yet. Doesn't mean they wouldn't be in the future. But we've now had more time to analyze. How to take action if they were passed? Since the proposed legislation would only affect grantor trust, one question was why not just hold life insurance and non grant or trust the great question, but it's not an easy answer. Pilots are typically grant or trust for several reasons, including to avoid transfer for value issues which we'll touch on shortly, avoid gain on sales. Who were from the Grand Tour and avoid interest income on loans to or from the Grand Tour since the Grand Tour is going to be treated as the owner of the entire island and its property for. Income tax purposes. Now code section 677-A3 is one of the triggers that's commonly used

for grant or trust status because it's easy to administer if it simply provides that if any income of a trust which is referenced as taxable income in the. Year that it's. Tax is used to pay premiums on life insurance policies. The Grand Tour or the Grand Tour spouse without the consent of an adverse party, which under the code is is a child or another beneficiary of the Isle, then that pilot is going to automatically view Grant or trust 67783 the hurdle to get around if you try to avoid grant or trust. Status because OK, small and IRS guidance indicate that it might not matter if the trust expressly prohibits the use of income, which creates a problem for drafting, or if the premiums must be paid from principal. So you could draft that in there. But IRS signs and case losses, that doesn't necessarily mean that the trust is going to be a non brand. Trust. And that's because the trustee could breach fiduciary duty and actually lose income to pay principal. Or they could not realize or might not realize that if they don't use the income in the year that it is tax but instead add it to principle and the principle is used in that year to pay income or to pay premiums, then that is technically the use of income to pay premiums. So it could be a mistake. Which could just be failure to administer properly or just not recognize that that's what's happening under the terms of the trust. So as you can see, we've created a lot of really new state planning community because it would be difficult to toggle off grant or trust status if these potential changes to grant full trust rules were enacted. And some possible solutions that people came up with would be to incorporate consent requirements of an adverse party, which is difficult for many people, particularly parents, to to contemplate because they don't necessarily want their children to know that they have a policy out here with multi millions of dollars. Going to be paid out when their parents pass, so convincing clients to give a beneficiary child that power to consent each time the premium is paid is. You also could say that the premiums have to be paid from a separate non interest bearing account perhaps, and that account is funded initially at the time the trust is funded, or you could use the income from the principle of the trust to hold that non interest bearing account and use it in future years. Pay premiums. So there are a few different options, but all of them are are difficult to follow, difficult to administer, and difficult to explain to clients. Now that we've talked about the the issues with toggling off grant or trust status and the the problems that the proposed legislation could create. Also mention a couple of other things that people did or thinking of doing in order to try to address the issue. It revolves around these Grand Tour trust islands, so one of them might have been to name multiple individuals as owners, and there are problems with that, so it's important to consider the ownership of the policy to ensure. One that it remains. Outside of the insurance taxable estate. But also that you can treat those premiums as annual exclusion gaps when a policy is held in a properly drafted eyelid, the premiums would qualify. The annual exclusion gifts to the beneficiary provided that you follow those rules with given crummy notices and having withdrawal rights under the document itself. But it's a policy is owned by more than one individual. Perhaps few children the insured wants their three children to be the owners they consider. We'll just use our annual exclusion gifts to pay the premiums on behalf of these three children, and it will be the same as. Pilot. But the problem is the children, as owners, would have to act together in order to do anything with that policy. And so. It may not. Qualify as an annual exclusion gift because each of those three children would have to be treated as having a present interest and power over that gift itself. That's really a problem that arises very quickly if you do individual people as being co-owners of Apollo. No two or more parties with the owner or the insured is a beneficiary. Being an owner isn't an issue that came up in the case of Goodman versus Commissioner, and this is really a situation where perhaps an insured spouse is the owner or a revocable trust of someone other than the insured in. The only in Goodman upon the insured's death, the owner would have been deemed to have native gift to the designated beneficiary other than the owner of the entire death benefit which would triggered. Gift tax.

So specifically in that case the wife creating the trust that was revocable by her during her husband's life to hold life insurance on her husband's life and designated that upon her husband's passing the proceeds from the insurance would pass to a trust for their three children. When her husband did in fact pass, she no longer had the power to revoke the trusts under the terms of the Trust agreement she created. And she was then determined to have made a completed gift of the entire death benefit to the children. So as opposed to gifting premiums or gifting the value of the policy at the time it was purchased, which is going to be much lower, she was deemed to make and get to the entire death benefit, which was much higher.

So actually, let's move on to the second. Topic in the article. Which is mistakes that trigger income tax and and I guess I would say along the same lines as mistakes that trigger gift taxes. There's there's potentially a number of actions that could trigger in. Tax specifically related to life insurance policies and some of the things that are mentioned, some of the things that we look at on a on a weekly basis, the Phantom income issue upon surrender or lapse of policies, maybe the tax upon surrender with the policy that has an existing loan is often open overlooked. You know I and I guess from our side of the house on the insurance. Business. You know what we would say is the insurance world, the insurance professionals out there, us included. Should always make sure that we ask the insurance carrier for a formal accounting of what the tax basis is. We we can't make the assumption that we know what the tax basis is and therefore calculate what a potential gain is. But what? What do you see as some of the mistakes that that could trigger income tax?

It is not uncommon for clients to reconsider insurance purchases. Regardless of what the tax laws are, and really it just their ideas around insurance change as their own personal financial situations change, their liquidity increases, they may have sold business interests and so they. May not feel. Like they need the liquidity that the insurance policy provides and really the proposed tax law change. We did incentivize more people to look at this sooner than they may otherwise have because they would have held the policies and life insurance trust they would been concerned about the grant or trust rules of keeping the policies. And so instead of of continuing to fund those, they would just allow them to collapse or surrender them. So whether the policies are held outright or in trust, it's important to remember that lapse or surrender. The policy may create taxable income to the extent that the payout exceeds the investment in the policy contract, which is a concept similar to base to basis. So again it it is very. Important that we don't just estimate that number that we asked the carrier for formal accounting like you said of the tax basis and an estimated calculation of what the gain would be if that happened. So just as when a surrender of the policy results in payment in excess of the investment for basis, there might be income tax consequences there where there's a loan on the policy. At the time of lapse or surrender that also could be treated as ordinary income, similar to forgiveness of debt. The same results from the trustee of an eyelet surrenders a policy and the income is taxable to the Grand Tour, or when the grant or trust status of the trust is terminated during the Grand Tours life, when there's an outstanding loan payable by the trust to a third party, perhaps in the case of of dollar arrangements where a third party. He's not the beneficiary. Who's not? The Grand Tour is paying the premiums for those policies in this situation, according to IRS guidance determination of the grant or trust status would be treated as a disposition by the grant tool for income tax purposes. So that the grantor has an amount realized equal to the outstanding debt, and if we're dealing with the cash loan, the basis in the property would be negligible. So a large portion of that amount realized would be subject to income tax at the time that the grant or trust status terminated during the life of the insured.

The third topic that you speak to is mistakes. When transferring a policy and or when I read this it it, it became clear that these are mistakes that are are very often overlooked. So this is another really important topic to to address. Would you speak to things such as the code section 2035 sale versus transfer of a policy? And then there's some exceptions to the transfer for value and maybe even address some of the gifting policies and what a what a Form 712. Might be that that's something that's important as we as we think about this, this topic.

OK.

So with the increased exemptions, the gift tax exemption GST exemption that most of our clients had over the last several years, people wanted to transfer policies that they owned into these life insurance trusts, even if the value of the policy might have been somewhat high. And who was going to be quite what the death benefit was. So a way to use their exemption code then to make an outright gift, they also could sell, but people tend to want to gift because it's simpler. Maybe it costs less because they don't have to to pay an attorney to draft the purchase and sale documents, and that sort of. Thing the problem. With making a gift is section 23. 25 What it does is it pulls the death benefit of the gifted policy back into the estate of the donor when the donor dies within three years of death. So if you haven't insured a client who's created a life insurance trust and they want to gift that policy to the trust just because it's. Quick and easy and simple. They do that, but then subsequently they pass within two to three years of the gift. The entire proceeds of the policy, the death benefit, could be pulled back into their taxable estate, so they're actually making the gift was really pointless. It didn't result in any benefit to them at. That point in time. Now there is a way to get around that. And again, if if the sale versus the gift transfer of the policy is an exception under section 2035, which says that if the policies serve for adequate and full consideration in the case of a policy transfer to an island, for example, as long as the trustee of the policy. Obtained the fair market value and it's purchasing the policy from the Grand Tour for that fair market value. Then technically 2035 does not apply to pull the policy back into the insured's taxable estate even if he or she dies within three years of the transfer. And because the grant was treated as the owner of the policy. And the trust for income tax purposes with there is not a realization that so it's not going to trigger gain. And as a result, this sale is going to be an attractive option for an older insured or an insured towards exhausted his or her gift tax exemption. So you always want to counsel the clients to to consider these options even if it may be a bit more timely or costly to go the sale route because especially in case of an older person. For someone who's in poor health, this is going to avoid that potential risk of including the policy proceeds in their state. But it's important to remember that specific facts and circumstances matter, so we can ensure it actually does die within three years of the sales are still might challenge the value used for the sale, and argue that the sale price actually should have been closer to the value of the death benefit than what the parties determined at the time of the earlier sale. Which level is much lower, and we get into how those policies are valued. This was the case in the Pritchard versus Commissioner, where the insured died 32 days after the sale of the policy to his daughter when he knew he was terminally ill, which was a much shorter time than calculated by the mortality tables on which the premiums were calculated. The court held that the value determined at the date of the transfer. Is technically recognized as the value of the policy for gift tax purposes, so they did acknowledge that that the the logs in the code state that they could use that. However, when death is known to be imminent, the value of the policy being transferred. Be based on the proceeds of the policy that would be received at the insured staff. Fortunately, this valuation issues were the only present when it was known that the insured was in courthouse or or with an advanced

age. Based on IRS guidance does support that when death occurs unexpectedly within three years, even though the IRS may audit. The transaction, the gift tax value would be respected. So you know, if you were, I went and sold our policy and then were hit by a bus tomorrow, the iris still would respect the gift tax value that we use because we don't expect that that's going to happen to us tomorrow. No. With respect to to tax free transfer, as I mentioned, when we're dealing with the Grand Tour Trust and the Grand Tour. It and then the grant toward being the the person who is actually selling the policy. There's not going to be a transfer for value issue there. We're not going to trigger a realization event. There's not going to be a capital gains tax. Associated with it. But there are some issues when you transfer policy to other people if the. Fail is not covered by. An exception to this rule, which is under. Section 101 A. Two, which includes transfers to the insurer, the Grantor Trust, spouse, a partner or corporation or partnership in which the insured has an interest. So those are the exceptions to the rule. If one of those exceptions does not come into play and the death benefit in excess of the policy basis plus consideration is treated as ordinary income, that's going to be taxable. So that can create. Quite a tax. At the time of the. Sale a transfer by sale to a non grantor trust may not qualify for an exception to the transfer. The value, unless it was considered a partner. Of the insurer. But remember, even if it did qualify for an exception, the transfer would still be a taxable event, since the trust is a separate and independent taxpayer from the seller. So again, another benefit to keeping these life insurance trust those grant or trust is we don't have to worry about that risk, but that risk can come into play when you're dealing with a transfer. To a family member of the insured who, other than the spouse, and really any other situation where they're not covered by these very slim exceptions.

So let's finish up here with the last topic that you mentioned in your article, and it's a big topic. It's mistakes in drafting insurance trust, so I'm going to let you address whatever you feel is appropriate to close out our podcast here for today with respect to mistakes in drafting insurance trusts.

A lot of this also goes back to what we spoke at, spoke about in the beginning regarding the Grand Tour Trust rules and the changes to the Grand Tour Trust rule. So some of these mistakes that I would like, you know, involve drafting others involve a combination of drafting and poor administration of these trusts. The trust is only going to be as good as the the parties who are administering it according to its terms with respect to drafting issues that can result in. Poor administration and then really failure of the entire plan. If we're dealing. With talk again about the non grantor islets. If we're dealing with the non grantor IRA. That is going to be receiving premiums from the non interest bearing account. Again, you have to be very careful that any interest that's being used to pay that with interest on which tax was paid in earlier years. There are also issues where parties have had other trusts. Or other individual. The rules pay the premiums for a what was supposed to be a non grantor islet, and they have determined that the trust that is paying the premiums for life insurance policy is going to be a a grant or trust, regardless of whether the trust agreement specifically says that it is not meant to do that. Or puts restrictions on how these premiums are supposed to be paid purely from principal, just the mere fact that trust means income to pay the premiums on a policy, whether the trust funds the policy or not. Can trigger grantor trust status, so again it's very very important to understand how 677 works and how that can trigger the treatment of all of the income of the trust is taxable to the grantor and Britain they just for for poor administration other drafting issues that frequently arise in the context of islands involve crummy withdrawal. Dollars, which can allow premium payments to or on behalf of the trust to qualify for annual exclusion. Gifts to the individual trust beneficiaries. So again this is beneficial because it does allow the Grand Tour to continue to fund the trust without necessarily using their gift tax and. When they're doing

this. However, they do need to work closely with their attorney or accountant to track whether the trust is going to have automatic allocation of GST exemption. This comes up often where people forget that part we don't have necessarily a GST annual exclusion unless the trust is dropped in a very specific. Right. But most of them are not, and so each time these premiums are paid, even if they qualify for the annual exclusion from gift tax, they may have automatic allocation of the lifetime GST exemption, which can run that number down fairly quickly and can result in a trust that does not have an inclusion ratio. Zero and can then create issues down the line when distributions are made to grandchildren. So there's that that concern. There's also the concern about not properly administering the Kremlin trust provisions. So you do have to make sure that notice is given to the beneficiaries and that we keep record of that notice, so that if there ever was an audit. We can support the fact that those annual premiums were covered by annual exclusion gifts. And then we also want to make sure the trust actually has those provisions in it. So I've come across a number of trusts that are meant to be life insurance trusts that don't actually have these premium withdrawal provisions in there. And so the client is arguing that they've only made annual exclusion gifts to this trust. They've never given notices to the beneficiaries. And the trust doesn't even have those withdrawal provisions in it. That can be quite problematic. The other issue that can arise is the provisions in the Trust Agreement, specifically saying that the annual exclusion guest for the withdrawal rate. Apply only to gifts to the actual trust, as opposed to indirect gifts to the trust, which could be made by the grant or paying premiums directly to the insurance company, and that hasn't happens more often than not, where a an empty islet that only holds a policy doesn't actually have a bank account. These premiums are being run through and instead the Grand Tour the insured is just paying the premiums directly to the life insurance company, treating them as annual exclusion gifts because they're indirect. That's and then realizing the trust doesn't actually say that they can do that, it only covers withdrawal rights for directives to the trust. So you have to be careful when you're drafting to make sure that any transfers to the trust, whether they are indirect or direct transfers, would be covered by these withdrawal rights so that they can qualify for. Final exclusion gift status and then of course the the best way to administer these trusts is to encourage the the trustee to actually open a bank account, even if it's just going to be an empty, non interest bearing account. And to run those premiums through the account before they're actually paid to the insurance company. Let them sit there for 30 or 60 days so that we can support the fact that the beneficiaries actually did have a present interest in the amount that was funding that account for the the withdrawal period of time that's designated by the Trust agreement and then have the trustee actually wire the money to the insurance carrier or or write a check. So we have a clear paper trail of this trust being in. The mustered properly. And the beneficiaries actually having the right to withdraw. Some actual cash value and then we can support all of that in.

The case of the future audit, actually this is really great information. We appreciate you sharing your time with us today. I'm going to allow you to to add any closing remarks or thoughts. If there's anything else you'd like to share with our audience.

So I think the most important thing to note is that 2021 was not the first year that we've had. Kind of rush to address potential issues that might arise, and I don't think it's going to be the last year that involving threats of significant tax law changes that would affect the work that we do for our clients. So it's important to be thoughtful when planning so that you don't end up putting clients in a worse position regardless of whether the laws change or not. So it it's never a good idea to rush to do planning that's going to affect our clients for the rest of their lives. And we certainly don't want them to come

back if the laws don't change like they think this time. And and and blame us for major changes in their plan that are not really what they intended. It may have resolved the short term worry and risk, but in the long term it's not going to be the best. Planning for them?

Thanks again Ashley. Thank you to your partner, Marianne Mancini, and thank you to Finn Seka for publishing this article and and introducing us. We appreciate your time today and look forward to to working with you. In the future.

Thank you.

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