At the Intersection of Wealth Transfer Planning and Life Insurance:

Navigating New and Existing Life Insurance Plans with Looming Tax Changes on the Horizon

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Current Circumstances

- Federal Gift and Estate Tax Exemptions - $13.61 Million
- Federal GST Exemption - $13.61 Million
- Federal Annual Gift Tax Exclusion - $18,000
  - $185,000 for non-citizen spouse

Potential Problems / Looming Changes

- Sunset of 2017 Tax Act in 2026 (transfer tax exemptions drop to ~$7Million)
- Future Increases in Federal Estate and Gift Tax Rates
- Application of Local/State Death Taxes
- Higher Interest Rates (have we seen the end/ceiling?)

What Should CLIENTS Consider

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- Use of Lifetime Gifts (remember you fill from the bottom), but understand “clawback” concerns
- Grantor Retained Annuity Trusts (GRATs)
- Qualified Personal Residence Trusts (QPRTs)
- Sales to Irrevocable Grantor Trusts (and Private Annuity Transactions)
- Intra-Family and Split Dollar Loans
- Spousal Lifetime Access Trusts (SLATs)
- Beneficiary Owned/Income (Defective) Trusts (BDITs or BDOTs)
- Remainder Marital Property Purchase Trusts
- Charitable Trusts, Donor Advised Funds (DAFs) & Private Foundations
- Irrevocable Life Insurance Trusts (ILITs)
- Decanting and Modifications for Current Trusts and ILITs

What Should CLIENTS Consider

- Asset Specific Planning
  - Marketable Securities and Closely-Held Business – GRATs
  - Real Estate (Primary and Vacation) – QPRTs
- Goal Based Planning
  - Health and Education – Annual Exclusion Gifts, including unlimited direct payments; 529 Plan Accounts; use of HEET Trusts (2611(b)(1))
  - Special Needs Trust Planning

What Should CLIENTS Consider

- State and local tax minimization strategies
- Possible refinance of current Notes and Sale Transactions to increase income?
- Time to reconsider ROTH IRA Conversions as a result of Secure Act changes

Where Does Life Insurance FIT

Where Does Life Insurance FIT

- Generate liquidity for estate expenses and family support
  - Avoid fire sales of estate assets
- Allow disparate distributions of estate
  - Family business/real estate to desired family members; equivalent cash to others
- Minimize conflict in planning for blended families
  - Insurance death benefits to children from prior marriages; estate assets for spouse
- Fund business succession planning
  - Provide surviving owner(s)/business with sufficient cash to buy-out deceased owner (and possibly certain other desired family members)

Where Does Life Insurance FIT

- Customize product to client circumstances
  - Liquidity protection/guaranteed death benefit
  - Retirement savings/cash value accumulation and access
  - Investment features/private placement options for appropriate cases
  - *Modified endowment contracts (MECs)/*tax implications for potential policy loans or future withdrawals
- Provide multifaceted tax planning
  - Income tax-deferred investment within policy
  - Tax-free access to cash value via policy loans/withdrawals of basis (non-MEC)
  - Estate liquidity without estate taxes at death (if owned in a properly structured ILIT)

What to LOOK for with Life Insurance

New Policies

- Match insurance product and features to client needs
- Review proposed policy owner and beneficiary
  - Have ILIT purchase at inception for estate tax protection
- Consider premium funding methods
  - Annual exclusions, large gift, split dollar or other premium financing
  - Should be sustainable for anticipated policy premium duration
- Watch for MEC status, especially if cash value access is important

Existing Policies

- Are they still needed (consider 2026 sunset, future client insurability)?
- Should they still be financially funded? To what extent and how?
- How are they performing? What changes can improve performance?
- How should they be used for wealth transfer planning (or does the current wealth transfer plan (ILIT, buy-sell, IGSD) still make sense)?
- Do the current policies and financing/payment arrangements still work?
- Do the product types/features continue to meet the client's needs?

Policy Illustrations

- Initial policy illustration (or “as sold” for existing policies)
  - Underwriting classification
  - Current assumptions and guarantees
  - Premium and planned duration
  - Pattern of projected cash value and death benefit at “relevant” ages
  - Policy construct/type
  - Cost of insurance/policy charges
  - Age policy matures
  - Long-term care/acceleration of death benefit options

Policy Illustrations

- Inforce illustration - existing policies
  - Same as an “as-sold” illustration but starts at current policy year
  - Report of annual policy charges and current policy statement
  - CONFIRM current policy owner AND beneficiary
  - WATCH OUT for:
    - Planned changes in policy structure, death benefit options, etc.
    - Timeframe for current premiums to support death benefit
      - Is policy underfunded/overfunded? Will it ever be self-sufficient?
    - Policy loans (and are they “problematic”)
    - Applicable index or investments of cash value (IUL or VUL policies)

ILIT-Owned Policies

- Existing or proposed ILITs:
  - Obtain and review a <u>signed</u> copy of trust agreement/governing documents
  - Funding method/treatment
    - Gifts (annual exclusion, exemption) and gift tax reporting
    - Split dollar (economic benefit or loan)
  - GST exempt status
    - Allocation of GST tax exemption and amount remaining for future funding
  - Grantor trust status
    - What triggers status? Who is treated as grantor?

Split Dollar Arrangements

- Obtain and review a <u>signed</u> copy of agreement and related documents
  - Collateral assignments, promissory notes, split dollar loan representations
- Confirm if economic benefit (EB) or loan regime
  - Compare projections for both – consider if a switch is needed/possible
- For EB:
  - Review projected annual EB to policy maturity and if using Table 2001 or carrier term rates – <u>**but still need to confirm carrier EB costs each year**</u>
  - If ILIT does not pay EB, confirm gift tax reporting/GST exemption allocation
  - Has/when will cash value exceed premiums paid (repayment equals cash value if greater)?

Split Dollar Arrangements

- For split dollar loans:
  - Track/confirm amounts, dates, and AFR for each loan made for premiums
  - Review if interest serviced annually or accrued/added to principal
  - Confirm exit strategy and if viable based on projected amount due
    - Repayment from death benefit, other trust assets, etc.
  - **REMEMBER** – a split dollar loan representation (even if the original one from the date of entering into the SDA) should be filed with income tax returns for EACH year a loan is made

How to Handle EXISTING Life Insurance and the "WHY"

Analyze Insurance and Structure (*Performing or Not?*)

- Does the client still need (or want) all the insurance?
  - If so, to what age?
  - If not, need (or want) a lesser amount and to what age?
- Is it about cash flow or the policy itself?
  - Cash flow - can adjustments be made (and is client willing)?
  - Policy - can it be managed to improve performance (without an exchange)?
- Is it about the carrier?
  - Drop in ratings, customer service?
  - Has the carrier changed?

Analyze Insurance and Structure (Performing or Not?)

- Is it about the gift/GST tax implications of paying premiums?
    - Ability to use increased exemptions before they expire?
- Is it about the premium payment arrangement or plan?
    - A split-dollar arrangement with no (or no longer viable) exit strategy?
    - Can it be fixed?
- Is it about the ILIT (and not the policy)?
    - Unhappy with current dispositive or other trust terms?
- Is it a combination of factors?

Review Potential Options

- Keep policy, manage cash flow and/or make policy “adjustments” (reduce outlays, stabilize performance, etc.)
- Keep policy and fix or undo ILIT and/or funding arrangement (reform/ modify/decant ILIT, fix split dollar plan, etc.)
- Surrender the policy
- Repurpose the policy for other investment objectives
- Exchange the policy for another policy or an annuity
- Sell the policy on the secondary market (Life Settlement)
- Donate the policy to charity

Keep Policy and Make Adjustments

- Identify cause of cash flow pressures to help determine solution
  - Is cash flow just not available (now or in the future)?
  - Are there too many competing needs for client's cash?
  - Did a drop in dividend or crediting rates require:
    - Higher premiums to support the death benefit or
    - The same premium to be paid for (way) longer than anticipated
- Consider policy adjustments to manage foreseeable cash needs
  - E.g., can premiums be delayed or reduced?

Keep Policy and Make Adjustments

- Solution depends on the policy:
  - Whole Life:
    - Get illustration showing change of dividend option from buying paid-up additions to reducing premium (client pays net premium)
    - **PRACTICE TIP:** Confirm can change option back without evidence of insurability
    - Be sure client understands the long-term impact of this change
  - Whole Life/Term Blend:
    - Can payments for cash building riders be reduced (and then resumed, if and when)?
    - Don’t be surprised if the premium cannot be reduced for the foreseeable future!

Keep Policy and Make Adjustments

- Solution depends on the policy:
  - <u>Current Assumption Universal life (CAUL)</u>
    - Confirm how much premium can be reduced and still support death benefit to target age
    - Will change from increasing to level death benefit significantly reduce annual premium(s)?
  - <u>Guaranteed Universal Life (GUL)</u>
    - Revisit duration of no-lapse (NL) guarantee - does client need the death benefit to that age?
    - Ask agent to illustrate reduction in premium followed by a future “catch-up” premium that MAY OR WILL restore guarantee
    - Consider getting a letter from carrier supporting the illustration and “toggle” of the guarantee

Keep Policy and Make Adjustments

- Solution may be in the policy:
  - <u>Variable Universal Life (VUL)</u>
    - Is client comfortable with VUL as an investment product?
    - Is so, can policy be managed differently to minimize inherent performance volatility?
    - Revisit asset allocation of the cash value, then, depending on policy's features:
      - Reallocate a growth portfolio to a more balanced fund/portfolio (either carrier offered or constructed by client (with investment advisor assistance))
      - Explore automatic rebalancing feature, if available
      - Allocate portion of cash value to a fixed account for carrier to take monthly cost-of-insurance and other policy expenses, rather charging pro-rata from all the funds

Keep Policy and Fix ILIT and/or Funding

- “Fixing” or “undoing” ILIT
  - Distribute/decant policy to new trust per trust terms or governing law
    - May need to notify beneficiaries and/or meet other trust/state law requirements
    - Consider state law implications and potential change of trust situs, etc.
    - Consider fiduciary exposure for trustee if proceed without beneficiary notice/consent
  - Judicial reformation or non-judicial modification of ILIT
    - Availability depends on governing law
    - Typically requires beneficiary (and sometimes settlor and/or trustee) notice/consent
    - Judicial proceedings will be more costly

Keep Policy and Fix ILIT and/or Funding

- “Fixing” or “undoing” ILIT
  - Distribute policy to adult beneficiaries (if ILIT permits)
    - Fiduciary issues for trustee if distribution made unequally or without beneficiary consent
    - Removes policy from a creditor and spouse protected entity
    - Distribution to multiple beneficiaries will require collective action to exercise incidents of ownership
    - Need to address funding if future premiums are required
  - Internal termination/amendment
    - ILIT may give independent trustee or trust protector power to terminate or amend terms
    - If terminated, policy is distributed to beneficiaries, with similar issues as above

Keep Policy and Fix ILIT and/or Funding

- “Fixing” or “undoing” ILIT
  - Sell policy to new trust for fair market value (FMV)
    - If sale is to a grantor trust, no gain recognized and exempt from transfer for value rule
    - How determine FMV (gift tax value, appraisal)? who decides? if use appraisal, who pays?
    - Buying trust needs funds to buy policy (gifts? loans? use existing trust with own assets?)
    - Potential fiduciary exposure for both trustees if trust beneficiaries are not the same
  - Sell policy to grantor for FMV
    - Similar considerations as above
    - Also removes policy from creditor and spouse protected entity (except to extent policy is otherwise exempt under state law)

Keep Policy and Fix ILIT and/or Funding

- “Fixing” or “undoing” funding mechanism
  - Use current gift/GST tax exemption to pre-fund future premiums
    - Eliminate administrative issues of annual exclusion gifts, beneficiary “Crummey” notices
    - Prepay policy premiums or invest funds and pay future premiums when due
    - Or use gift to repay/terminate existing split-dollar plan (below)
  - Modify/terminate/refinance existing split-dollar/financing plan
    - BEFORE taking any action – confirm “grandfathered” status of plan
      - Different tax rules apply for split dollar arrangements created or materially modified after issuance of final regulations (Sept. 17, 2003)

Repurpose the Policy

- Redeploy a policy bought for traditional death benefit as an investment/retirement vehicle
- Depending on policy type/terms, it may be attractive as part of a diversified investment portfolio under current tax laws
  - Cash value grows tax-deferred
  - For non-MEC policies, tax-free access to cash value via policy withdrawals (up to basis) or loans (even in excess of basis)

Repurpose the Policy

- Start with illustration on how policy can be used for retirement planning
  - More than just picking an age and showing a series of withdrawals and/or loans
  - Should illustrate premiums, lower death benefit, and optimal/coordinated timing of policy loans/withdrawals
- For ILIT-owned policies:
  - How (and at what tax cost) can it be owned by or benefit the grantor and/or spouse?
  - Can grantor "swap" policy out of ILIT? If not, will trustee agree to sell it?
    - Policy valuation and creditor protection issues as noted above
    - Trustee has fiduciary duty to protect interest of beneficiaries

Repurpose the Policy

- Policy type also affects repurpose options
  - Whole life: Little flexibility as to premiums or other policy design aspects
    - Consider policy exchange?
  - Whole life/term blend: Potentially increase premiums (to build more cash value) without evidencing insurability
  - GUL: Potentially increase premiums (now viewed as investment contributions) without evidencing insurability
    - But may not generate "robust" cash value increases on a current assumption basis
    - Consider policy exchange?

Repurpose the Policy

- Policy type also affects repurpose options
  - CAUL or VUL - more fundamental design changes may be feasible
    - Combine higher premiums for a number of years with a reduced death benefit to limit "drag" of cost of insurance on cash value accumulation
      - Must be within carrier and tax guidelines to remain qualified as "life insurance"
      - Navigate requirements for underwriting, imposition of surrender charges, possible recapture tax from death benefit reduction, etc.
    - Project maximum tax-free cash flow access at retirement by loan and/or withdrawal
      - Without requiring more premiums to support death benefit beyond client's life expectancy
      - Illustration should show how any loan and interest works

Surrender the Policy

- Ask carrier for a “surrender quote” for current cash surrender value
- But PROCEED WITH CAUTION:
  - Cash surrender value in excess of investment in the contract (i.e., premiums paid less non-taxable distributions) is ordinary income, not capital gain
  - For MECs, 10% penalty tax applies on the income realized, if the taxpayer (not necessarily the insured) is under 59½
  - Outstanding policy loans at surrender generate tax to policyholder on excess of gross cash value (including loan amount) over investment in the contract
    - BE WARY as may produce less cash but significant income recognition
    - BE CAREFUL with non-grantor trusts as trust will be liable for any tax

Exchange the Policy

- When client wants coverage but is unhappy with current carrier, policy type, required (and immutable) outlays, etc.
  - Significant reason -- coverage for potential long-term care costs
- Some CAVEATS:
  - Is new really better than old?
  - Consider all effects of exchange on policy and funding arrangements
    - Material modification of a grandfathered (pre-final regulation) split-dollar plan?
  - Client must be insurable to make exchange

Exchange the Policy

- Tax implications
  - Code §1035 exchange - no gain or loss recognized on exchange of one policy for another on <u>same insured</u> or for an annuity if <u>no "boot"</u> is received
    - Different carriers and policy types can be involved in the exchange
    - Basis in old policy carries over to new policy - may be helpful to preserve basis even if there is no gain in the policy
  - Be CAREFUL of the "boot"!
    - Any outstanding policy loan extinguished in exchange is boot - taxed as ordinary income (without generating any cash)
    - If loan is carried over to new policy, there is no boot

Exchange the Policy

- Implementation considerations:
  - Timing is KEY – maintain current policy until replacement is in force
  - Internal exchanges (same carrier) vs. external exchanges (new carrier)
    - Always start with existing carrier – may have an internal exchange program
    - **Practice Tip:** If using same carrier, confirm that illustration is coded as an internal exchange
  - Potential benefits of internal exchange:
    - Less rigorous underwriting
    - Surrender charge on old policy might be waived
    - Commission on new product reduced or eliminated
    - Sales loads and premium tax may be reduced or eliminated

Exchange the Policy

- Exchange for an annuity
    - Tax aspects
        - Exchange can be tax-free under Code §1035 if no “boot”
        - Basis in policy carries over to annuity
    - Exchange for an immediate annuity - guarantee a lifetime income
        - But compare to a systematic approach to taking income from the policy
    - Exchange for a deferred annuity - maintains tax deferral
        - But client must understand key tax differences between cash value life insurance and deferred annuity to both owner during life and to the beneficiary

Sell the Policy (Life Settlement)

- Sale of a policy (past contestability period) in the secondary market
  - Price is less than policy's face value but more than cash surrender value
- Eligible policies - certain policies perform better in the secondary market
  - Preferred policy types are UL, VUL, IUL and convertible term
  - Buyers also may buy GUL and NLGUL products without reviewing medical records
  - Buyers prefer policies with low/no cash value or policy loans
    - Policies with a high cash value or loans may leave less net death benefit for the buyer
  - Life expectancy of insured is KEY
    - Life expectancies generally under 20 years, with thresholds between 3-15 years
    - Younger insureds with chronic illnesses may qualify

Sell the Policy (Life Settlement)

- Reasons to consider include:
  - Client still plans to discontinue paying premiums after review of other options
  - Changes in client's family or financial circumstances have eliminated original insurance needs (e.g., liquidity event, divorce or death of a spouse, etc.).
  - Policy is underfunded and/or underperforming and additional premiums are needed
  - Policy acquired for buy-sell funding or key person coverage is no longer required
  - ILIT trustee wants to mitigate fiduciary risk against potential beneficiary challenges to policy surrender of intra-family sale or distribution
  - Exit option from a premium financing or split dollar arrangement
  - As part of portfolio reviews for older clients with multiple policies to manage the policies in a way that maximizes the wealth transfer

Sell the Policy (Life Settlement)

- Tax implications to seller (client)
  - Policy <u>surrenders</u> are taxed as ordinary income under Code §72(e)
  - BUT policy <u>sales</u> are taxed as sales of capital assets under Code §1016(a)(1)(B)
    - Gain (capital) = sale proceeds - owner's "adjusted basis" in policy
    - Basis is adjusted by items properly chargeable to capital accounts but <u>not</u> for mortality or other reasonable policy charges (i.e., cost of insurance).
  - Enactment of Code §1016(a)(1)(B) dismissed prior IRS position that policy's basis for sale purposes had to be reduced by cost of insurance
    - BUT exceptions to the taxation of the policy death benefit to the purchaser under the transfer for value rule also were eliminated

Donate to Charity

- Potentially significant donation at a low cost outlay
  - Confirm charity's internal policy/requirements on acceptance of policy
  - May only accept paid-up policies or request added gifts for any future premiums
- Donor may be entitled to current income tax deduction for gift
  - Transfer must include all donor's incidents of ownership in the policy
  - Must comply with the partial interest rule – if violated – deduction denied
  - Some uncertainty in determining deduction amount
    - Is policy "ordinary income property" or a "capital asset" for this purpose
  - Must comply with applicable reporting requirements
    - File Form 8283, obtain "qualified appraisal" from "qualified appraiser" if gift over $5,000

So, What do YOU Do (Final Thoughts)

So, What Do YOU Do……..

- Engage with clients NOW
  - Planning evaluation and implementation takes time
  - Heightened demands on advisors/financial institutions as 2026 nears
- Knowledge is KEY
  - Identify what is really important to client/families (the WHY)
  - Any health or medical concerns that require special planning?
  - Any potential beneficiaries in need of Special Needs Trust planning?
- Collaboration is VITAL
  - Coordinate with the allied advisory team (CPAs, financial and insurance advisors)
  - Open communication and sharing of information avoids surprises

Questions and Answers….

THANKS FOR ATTENDING

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