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For Trusted Advisors

NEW YORK LIFE

Life insurance planning in the new environment.

By Martin M. Shenkman, CPA, MBA, PFS, AEP® (Distinguished), JD

The 2017 Tax Act dramatically changed income and estate planning.

The high estate tax exemption, $11.18 million/person, has made the estate tax irrelevant for almost all taxpayers. But the actual implications are more complex.

A number of different income tax changes, the doubled standard deduction, restrictions on state and local taxes, and the new 20% deduction for pass-through entities under Code Section 199A, have changed how income tax planning is approached by many.

How have all these changes affected planning generally, and insurance planning in particular? In many ways. Many of these changes indirectly affect insurance planning and insurance trusts, as will be explained. All of this is important for insurance consultants to understand the mix of trusts that clients will need, which can and cannot hold life insurance, and how insurance planning integrates into this new environment.

Use temporary exemptions

The estate tax exemption is scheduled to drop by about half in 2026, and a different administration in Washington could change it before that. This means that clients with estates substantially below the current exemption amounts should plan to use those temporary exemptions before they are lost. Because it is more important than ever for most clients to maintain access to assets they transfer to trusts, planning to use even part of such very large exemptions is necessarily different than it has historically been. This presents unique planning issues.

A client can transfer assets to a trust and preserve access in many ways:

- The client's spouse can be named a beneficiary.
- Someone can be given the right to loan the client trust assets without requiring adequate security.
- Someone can be given the right to add new beneficiaries to the trust, including the client.

These options to access assets given to an irrevocable trust all share a significant tax consequence; namely, they result in the trust being characterized as a grantor trust for income tax purposes. Under prior law, that was a generally desirable result, and in some instances, it is still a desirable result. But in many instances, it is not. Understanding why, and what can be done, goes to the heart of how planning, including insurance planning, has been transformed.

Non-grantor trusts for income tax benefits

If clients create non-grantor trusts, important income tax benefits can be achieved. Non-grantor trusts are trusts that pay their own income tax, in contrast to the grantor trusts above, whereby the settlor creating the trust pays the income tax on trust income (even if that income stays in the trust).

Here are some of the income benefits of a non-grantor trust:

- Trusts have no standard deduction, so trusts can allocate gross income to charity and provide a dollar for dollar deduction. In contrast, with an approximately doubled standard deduction, now $24,000 for married couples, few taxpayers will realize an income tax deduction for donations.
- If a non-grantor trust owns a portion of a taxpayer's home and pays the allocable portion of property tax using income the trust earned (for example, on investment assets given to the trust), the trust may qualify to deduct up to $10,000 of property tax deductions. Multiple trusts may be used to salvage all of the

taxpayer's property tax deductions that the new $10,000 state and local tax limitation would have otherwise eliminated.

- Taxpayers that own pass through businesses, are subject to a phase out of the new 20% deduction on qualified business income. For a married couple this phase out begins at $315,000. So, if the taxpayer can gift percentage interests in the business to different non-grantor trusts, e.g., one for each child, each trust would have its own phase out range beginning at $157,500. Thus, non-grantor trusts may provide a means to enhance this new 20% tax deduction.

Structural challenges of new trusts

Structural challenges arise, however, when creating trusts to achieve the simultaneous goals of enhanced income tax benefits, use of the temporary gift/estate tax exemption through completed gifts, and preservation of access to transferred property by the settlor. How can these three seemingly disparate goals be achieved? As described above, the right to add a beneficiary or loan the settlor money without requiring adequate consideration must be excluded, or the trust will be considered a grantor trust which will negate the income tax benefits. If a spouse is to be a beneficiary, the spouse's right to receive a distribution must be made contingent on the advance approval of an adverse party (e.g., a child who is a remainder beneficiary). With careful planning, trusts can be crafted with these characteristics to achieve the disparate goals many clients have in light of the 2017 Tax Act; but planning considerations are new and different.

Add insurance to the mix

How do these new trusts and this new planning environment affect life insurance trust planning? If a trust can use trust income to pay premiums on life insurance on the life of the settlor creating the trust, that will likely trigger grantor trust status for income tax purposes. Furthermore, many traditional insurance trusts are established as spousal lifetime access trusts, or SLATs, which also generally confers grantor trust status. As a result, separate insurance trusts will generally have to be maintained if non-grantor status is desired for income tax purposes for other transferred property.

Additionally, grantor trusts still have a place in a client's planning. For example, if they have highly appreciating assets, or negative basis real estate that they wish to secure a basis step up on death, grantor trusts can include a swap power that permits the settlor to swap appreciated assets back into his or her estate for an equivalent amount of cash. Therefore, grantor trusts will continue to be used and created in appropriate circumstances, integrated with the insurance plan, and own life insurance.

Newly established non-grantor trusts, however, may be the primary components of the client's plan for income tax purposes. Of course, if non-grantor trusts hold a significant portion of the client's wealth but cannot hold life insurance, how might ongoing insurance premiums be paid? One option may be for the non-grantor trust to loan money to a grantor life insurance trust, perhaps using a split-dollar loan arrangement.

Conclusion

The nature of trust planning for a large portion of clients will change substantially as a result of the 2017 Tax Act. Clients should seek to utilize as much as feasible of the new large estate tax exemptions before that largess sunsets in 2026. But when these new trusts are structured to garner income tax benefits as non-grantor trusts, those new trusts should generally not also own life insurance. The entire mix of trust, planning, ownership and use of life insurance will all change.

To the extent that insurance consultants can understand and work with clients and their planning teams in this new environment, insurance can remain a vital and properly planned component of most estate plans.

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Taxation - Income, Estate and Gift

The QBI deduction: Qualifying factors for the §199A reduced business tax rate.

By Brian Lamborne, JD, LL.M.

The Tax Cuts and Jobs Act of 2017 ("Act") made substantial changes to the tax code, including lowering the highest individual tax rate to 37%, lowering the corporate tax rate to a flat 21%, and creating §199A of the tax code.

Section 199A created a 20% deduction against certain "qualified business income" (QBI) from pass-through business entities—S corporations, partnerships and sole proprietorships. This deduction was created to "level the playing field" with C corporations as a result of lowering the corporate tax rate to 21%. However, while all C corporations receive the 21% tax rate, the rules around the QBI deduction result in some owners of pass-through entities receiving reduced deductions as a result of certain limits, or losing the deduction completely.

With planning and some changes, some business owners may be able to mitigate the effect of these limitations.

The basics

The §199A statute creates three categories of taxpayers for QBI purposes.

BUSINESS OWNERS REPORTING <$315,000 OF TAXABLE INCOME: All business owners who report taxable income from all sources of less than $315,000[1] receive a 20% deduction on all pass-through income they report. QBI does not include wages received from a pass-through, guaranteed payments (from a partnership), or capital gains or dividends passed through from the entity.

BUSINESS OWNERS REPORTING >$415,000[2] OF TAXABLE INCOME WHERE THE QBI IS NOT FROM A "SPECIFIED SERVICE PROVIDER" (SSP[3]): Business owners who report more than $415,000 of taxable income from all sources and who are not SSPs receive a deduction equal to the lesser of 20% of QBI or the greater of 50% of wages or 25% of wages plus 2.5% of the basis of the company's assets.

BUSINESS OWNERS REPORTING >$415,000 OF TAXABLE INCOME WHERE THE QBI IS FROM AN SSP: Business owners who report more than $415,000 of taxable income with QBI from an SSP do not receive a QBI deduction. This limitation applies only to the income from an SSP. Where a

1 The $315,000 and $415,000 thresholds are for taxpayers who are married and filing jointly. The thresholds for all other filers are $157,500 and $207,500. For ease of reading, only the $315,000/$415,000 thresholds will be used.

2 Note that taxpayers, whether specified service providers or not, who make under $415,000 but more than $315,000, may receive a deduction as well. However, the range between $315,000 and $415,000 is a phase-in of the limitations created by the statute. An understanding of this phase-in is not necessary for purposes of this discussion.

3 An SSP is a trade or business that performs services such as medical, dental, accounting, legal, actuarial, consulting, performing arts or athletics, or financial, brokerage or investment management services. Architects and engineers were omitted from the specified service provider limitations.

business owner reports income from an SSP as well as a non-SSP source, the income from the SSP will not be subject to a deduction, while the income from a non-SSP source will be subject to a QBI deduction, subject to the rules described above.

How do these rules work?

The following examples illustrate how these rules work.

1. George and Louise own G&W Auto Repair, an LLC taxed as a partnership. They report taxable income of $200,000 in 2018, all from G&W Auto Repair. Because they operate a pass-through (an LLC taxed as a partnership), all $200,000 will be considered QBI. Because they report taxable income of less than $315,000, they will receive a 20% deduction against all of their QBI. This results in a deduction of $40,000 (20% x $200,000), meaning that they will pay taxes on $160,000 ($200,000 minus $40,000).

2. Example 2 is the same as example 1, above, except that George and Louise operate G&W Discount Brain Surgery, an SSP that provides discount brain surgery and also sells used video game systems. They will again receive a deduction of $40,000, even though their income is from an SSP. This is because they report taxable income of less than $315,000. ALL business owners with taxable income of less than $315,000 receive the QBI deduction without the limitations discussed above.

3. Example 3 also is the same as example 1 except that George and Louise report taxable income of $800,000, all from G&W Auto Repair. In addition, G&W Auto Repair pays wages to its employees of $100,000, and has assets with a basis of $100,000. George and Louise will receive a deduction of $50,000 and will pay taxes on $750,000.

   This is because they receive the lesser of:

   a. $160,000 (20% of QBI of $800,000); or
   b. The greater of:
      i. $50,000 (50% of wages of $100,000); or
      ii. $27,500 (25% of wages of $100,000 + 2.5% of assets of $100,000).

   Notice that the deduction has been limited to $50,000 even though 20% of QBI is $160,000. This is because of the low wage and asset basis.

4. Example 4 is the same as example 3 except that George and Louise again operate G&W Discount Brain Surgery. Because they report taxable income in excess of $415,000, income from an SSP will not receive a deduction. All of their income is from G&W Discount Brain Surgery, an SSP, therefore, they will not receive a deduction and will pay taxes on all $800,000 of taxable income.

Without planning, business owners in categories 3 and 4 may have the deduction limited substantially, or may lose it completely. However, by knowing the rules, George and Louise can maximize their deduction, by:

- Ensuring the entity they operate is appropriate for maximizing the deduction, and
- Splitting SSP and non-SSP business lines into different companies.

There may be additional options available to business owners, depending on their situations.

Changing entity taxation

In example 3, George and Louise operate G&W Auto Repair, which is taxed as a partnership. The deduction is limited because of the low wages and assets of the company. In addition, because G&W Auto Repair is taxed as a partnership, George and Louise cannot receive wages. Owners of partnerships receive guaranteed payments, which are not treated as wages for purposes of §199A.

In order to maximize the deduction, George and Louise should consider making an S election for the LLC. Owners of entities taxed as an S corporation do receive wages from the business that will be counted toward the wage base.

By making an S election for G&W Auto Repair and each taking a salary of $100,000, George and Louise will increase their QBI deduction, even while the QBI from the company is reduced because of the additional wage expense. These changes will increase their QBI deduction to $120,000, which will result in their paying taxes on $680,000 rather than $800,000.

This is because they will receive a deduction equal to the lesser of:

- $120,000 (20% of $600,000 [original income of $800,000 - $200,000 for wages paid to George and Louise]); or
- The greater of:
  i. $150,000 (50% of $300,000 [original wages of $100,000 + $200,000 of wages paid to George and Louise]); or
  ii. $77,500 (25% of $300,000 + 2.5% of assets of $100,000).

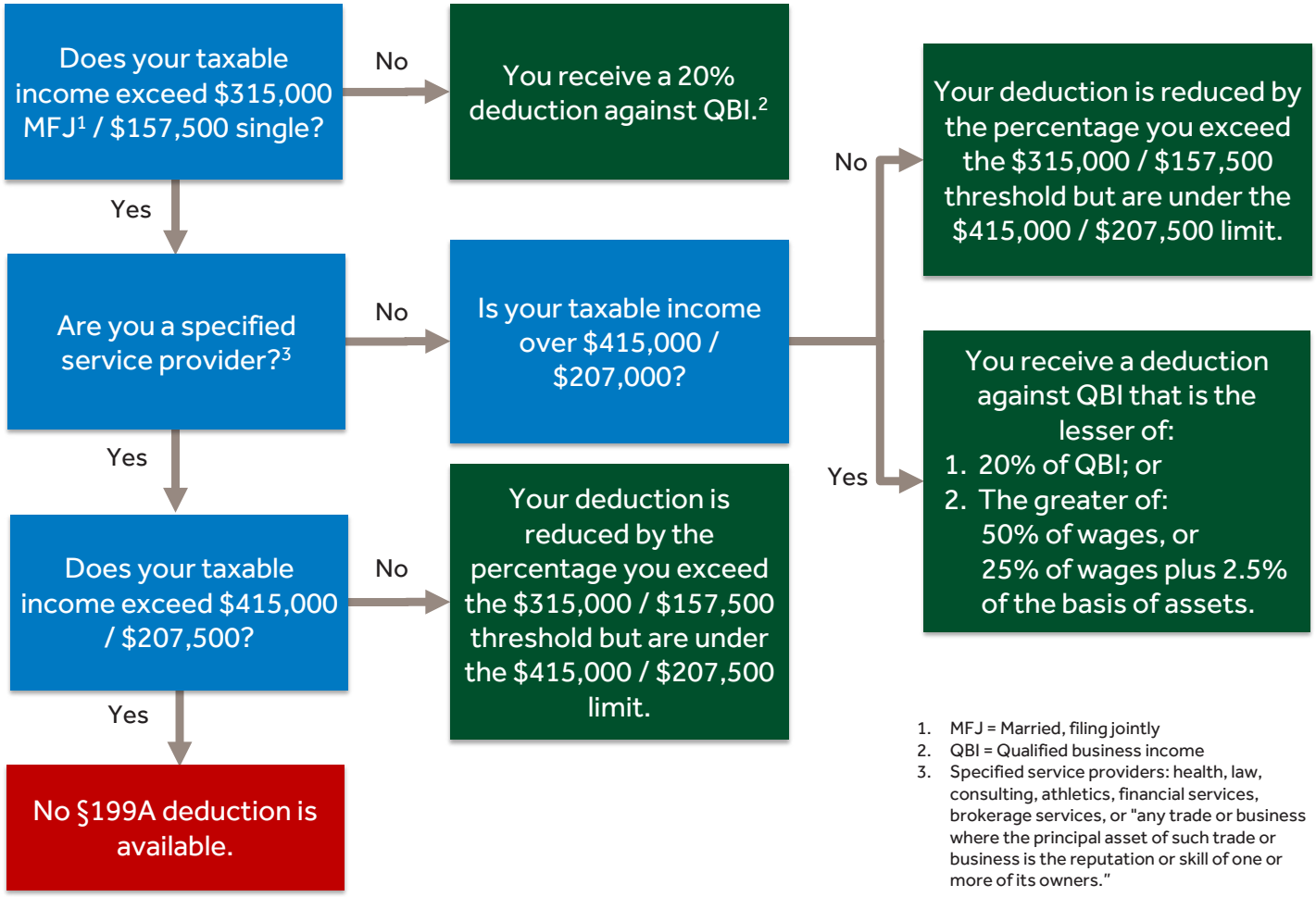
As you can see, using the proper entity can significantly impact the deduction.

Splitting SSP and non-SSP activities into different entities

In example 4, George and Louise operate G&W Discount Brain Surgery, which provides discount brain surgery services and sells used video game systems. The brain surgery services are considered to be provided by an SSP because they are medical services. However, the sale of used video game systems would not be considered income from an SSP if it was not provided along with the brain surgery services, because it does not meet the SSP requirements.

In order to take advantage of the QBI deduction rules, George and Louise should consider creating a new S corporation, George's Used Stuff Emporium, to sell the used video game systems. By doing so, they will have one entity, G&W Discount Brain Surgery,

Will Your Pass-Through Benefit from the Reduced Business Tax Rate?



1. MFJ = Married, filing jointly
2. QBI = Qualified business income
3. Specified service providers: health, law, consulting, athletics, financial services, brokerage services, or "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners."

The diagram above is a decision tree provided to help determine whether the pass-through income from your business will qualify for the Section 199A deduction.

that will be an SSP, and George's Used Stuff Emporium, which will not be an SSP. If $300,000 of the income from G&W Discount Brain Surgery can now be attributed to George's Used Stuff Emporium, then that $300,000 will now be eligible for the QBI deduction (subject to the statutory limitations discussed above because their taxable income exceeds $415,000), while the remaining $500,000 will not be eligible as income from an SSP.

While the statutory language of §199A does limit the 20% deduction, by learning the rules and planning ahead, owners of pass-through entities can mitigate, and in some cases, eliminate these limitations. By talking with their tax counsel about their current situation, as well as their future plans, and by making some changes to their operations, business owners may be able to maximize this deduction.

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Retirement Planning

401(k) Rollovers: Consolidation factors to consider.

By Eva Stark, JD, LL.M.

The average 50-year-old has held 11.9 jobs since reaching adulthood,[1] and younger generations may hold even more jobs by the time they reach the same age. As a result, in the absence of planning, an individual's retirement savings can become scattered among a multitude of accounts and be easily forgotten. Consolidating retirement accounts can help manage accounts and track progress toward retirement goals. However, before rolling over an old pre-tax 401(k) account into a new employer's 401(k) plan or a traditional IRA, several important factors must be considered.

PLAN INVESTMENT OPTIONS. One potential drawback to 401(k) plans is that investment options are limited to those offered by the plan. As a result, it is important to compare the investment selections offered by both the old and the new employer's plan before making a rollover decision. IRAs typically offer a much broader array of investment options for more customized investment strategies.

FEES. A 401(k) plan may charge fees such as administrative fees, investment fees, advisory fees and individual service fees (such as fees charged for setting up a loan). On the other hand, some 401(k) plans have low fees and offer low-cost "institutional shares" that are not available for IRAs. Before rolling funds out of a 401(k) plan, it is important to understand its fee structure.

Many employees pay little to no attention to fees, but a small difference in fees can have a substantial impact over a working career. While an employee has no control over the fees charged by his or her 401(k) plan, an individual may select among a multitude of financial institutions for an IRA to find the best value for his or her investment needs.

CREDITOR PROTECTION. 401(k) plans are ERISA qualified retirement plans that are typically protected from judgment creditors. Some limited exceptions include ex-spouses under a Qualified Domestic Relations Order (QDRO) and federal tax debts. In contrast, IRAs are not ERISA protected, although many states protect them under their exemption statutes. While some states offer full protection of IRAs, others may offer more limited protection, such as by capping the amount protected at a certain dollar amount. For those with asset protection concerns, it may be prudent to contact an attorney before rolling funds out of a 401(k) plan.

EARLY RETIREMENT. For individuals who plan to retire early, leaving funds in a 401(k) plan may help avoid the 10% early withdrawal penalty. An individual who leaves an employer after attaining age 55 may generally withdraw funds from that employer's 401(k) plan penalty free. In contrast, funds in an IRA may only be accessed penalty free after age 59½.

1 "Number of Jobs, Labor Market Experience, and Earnings Growth Among Americans at 50: Results from a Longitudinal Survey." Bureau of Labor Statistics. August 24, 2017. Available at https://www.bls.gov/news.release/pdf/nlsoy.pdf

EXTENDED CAREER. Many 401(k) plans will allow employees working past age 70½ to forego required minimum distributions. In contrast, an IRA owner must take required minimum distributions, regardless of employment status. For those who anticipate extending their careers, rolling funds into a new employer's 401(k) may help achieve additional tax deferral.

LOANS. While some 401(k) plans permit loans, IRAs do not. Individuals who desire to take loans from a 401(k) plan should review their plan documents to determine if loans are permitted. Loans must typically be repaid within 60 days of termination of employment, otherwise, income tax and a 10% early withdrawal penalty may apply.

WITHDRAWALS. IRA funds may generally be withdrawn at any time. 401(k) funds may typically only be withdrawn if employment is terminated, the employee attains age 59½, or the employee becomes eligible for a hardship withdrawal under plan rules. While some 401(k) plans allow "in-service distributions," this is not always the case. Early withdrawals either from an IRA or a 401(k) plan will typically trigger income taxes and an additional early withdrawal penalty of 10%. A handful of exceptions to the penalty (but not the tax) may be available, which differ slightly for IRAs and 401(k) plans.

NET UNREALIZED APPRECIATION. The rollover of company stock from a 401(k) plan into an IRA will generally cause the loss of preferential tax treatment on net unrealized appreciation. Company stock may be withdrawn from the 401(k) plan so that only the basis in the stock is taxed at ordinary income tax rates, while the gains (i.e., the net unrealized appreciation) are taxed at capital gains rates. To preserve this preferential treatment, it is important not to overlook company stock when considering a rollover.

Summary.

Over a working career, an employee may accumulate multiple retirement accounts. Evaluating whether and when to roll over funds into a new 401(k) plan or an individual retirement account may be a complex financial decision with potential pitfalls for the uninformed. The expertise of a trusted financial professional may be very valuable when making such an important decision.

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Eva joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.