SUMMER 2018

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NEW YORK LIFE

Asset Protection

A New Task for Financial Professionals: Digital Asset Management

By Jamie Hopkins, Esq., LL.M., MBA, CFP®, RICP®

The digitalization of assets is changing estate planning forever. Traditional tangible assets like stores, offices, currencies, and photographs have become digitalized, and recharacterized into something more akin to an intangible property asset. Digital asset planning creates unique challenges for estate and tax planning for which traditional planning techniques are unable to handle. This is no surprise as the law and best practices for estate planning have been lagging behind technology for decades. While hard-to-value assets (like patents, songs, and artwork) have always created both tax and estate planning problems over the years, the digitalization of assets has amplified these concerns, rendering many estate plans in existence today woefully out of date. At the same time, digital assets present technological progress, open up opportunities that have never existed, and present intriguing planning opportunities.

WHAT ARE DIGITAL ASSETS?

Digital assets are not computers, cell phones, or other electronic storage devices. They are better defined as the data stored on these devices. Think of digital assets as emails, online web pages, social media accounts, and cryptocurrencies like Bitcoin. Traditional mail was typically produced and sent in a physical form, but now much of our correspondence is digitalized in email form. The traditional family photo album is now stored online. Stores have moved online to the point that many companies no longer have a physical location but rather sell everything through an online website or storefront.

WHY DO DIGITAL ASSETS REPRESENT A PROBLEM FOR TRADITIONAL PLANNING?

From small businesses, international corporations, to individuals, almost everyone today relies on and uses digital assets in the course of their daily lives. Nevertheless, very few people have a good plan in place for how to transfer these digital assets at death, or how to manage the assets during a time of incapacity. This is perhaps the biggest issue today – the mere lack of planning when it comes to digital assets. The second largest issue is ownership. Most digital assets, like a Facebook page or Yahoo email account, are controlled by the Terms of Service Agreements (TOSAs) that users enter into when they set up their accounts. These TOSAs often have language around the ownership of the asset, limitations on the ability to transfer the asset at death, and even prohibitions regarding sharing access information to the account, like a username or password. To understand ownership rights and transferability rights of a specific digital asset, one must start with the TOSA.

Even if ownership of the digital asset can be transferred to another party upon death, traditional estate planning tools like wills and trusts are often inadequate to handle the challenges single-handedly. Location and access create two major obstacles that cannot be solved by simply having a will or trust in place. Locating an individual's digital assets can be challenging, as there is not a clear paper trail. Many people now have hundreds of different online accounts, each of which could need some level of management upon the death or incapacitation of the owner. Finding these accounts can be a wild goose chase.

Many people now have hundreds of different online accounts.

Today, best practice is still for users to keep track of all of their online accounts. This also means documenting any access information, like passwords, usernames, or pins. This information needs to be stored outside of the will or trust, a need which creates its own set of issues. Practically speaking, the usernames and passwords change too frequently to store in a legal document. In addition, listing out all accounts in a will could create a real security issue if it were to become public during probate.

Another factor facing the management of digital assets today is valuation. Some digital assets have clear and straightforward valuations, while other assets present more of an issue. For instance, a blog that generates a certain amount of monthly income can be valued like any other business or income source. However, assets like Instagram accounts, emails, or online photos, might not have much monetary value, but could represent significant sentimental value to the owner.

THE COMPLICATIONS DO NOT STOP THERE.

The growth of digital currencies is stretching planning and the law to its limits today. Popular digital currencies like Bitcoin, Etherium, Litecoin, and Ripple have soared into the spotlight over the past few years. However, digital currencies have been around for decades. Things like airline miles, credit card points, and hotel rewards are essentially digital currencies offered or backed by one company with a clear economic value. In fact, the IRS has stated in the past that airline miles that can be redeemed for cash can represent taxable income. However, valuing these assets can be challenging, even with the growth of exchanges to sell the assets, because many of the digital currencies trade for different amounts at the same time across multiple exchanges.

Furthermore, digital currencies have seen fluctuations of 30 to 40 percent drops in a single day, and increases of three or four multiples in just a few hours. The volatility of digital pricing, the lack of clear and distinct economic value, and widespread disagreement on valuation at any one point create serious valuation problems for digital assets. The IRS does not treat digital currencies like currencies at all, but more like gold or other commodities. This has actually increased the complexity of taxation issues surrounding the assets, because any transaction (like mining, selling, or exchanging) basically creates a taxable event. As such, anyone passing away with digital currencies should also report the income and value in the estate.

With a slew of issues surrounding digital asset planning on the horizon, state legislatures have begun to tackle a few of the main issues. The Revised Uniform Fiduciary Access to Digital Assets Act (RUFADA) was developed by the Uniform Law Commission in 2015. During 2016 and 2017, most states passed a version of the bill; a handful of holdout states have not yet passed a version of the bill, but have introduced it in their state legislatures in 2018.

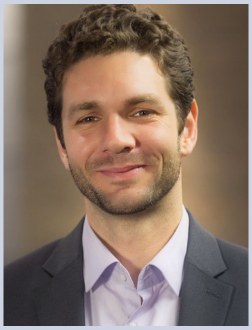
SO WHAT DOES RUFADA ACCOMPLISH?

RUFADA essentially sets forth best practices for estate planning with regard to digital assets. The law states that if the individual does no planning, then the TOSA will control whether or not the individual's fiduciaries, like a power of attorney or executor, can access any digital assets. However, if the individual specifically lays out digital asset access to their fiduciary in a will, trust, or power of attorney document, the fiduciary will have access to the individual's digital assets to essentially bring them to closure like any other asset. However, the bill does call on the individual to specifically lay out "digital assets" as language in the documents. Simply granting your fiduciary access to "all assets" will not be sufficient in most states.

Practically speaking, with the passage of RUFADA, many wills, trusts, and powers of attorney documents may be out of date and should be revised to specifically address digital assets. RUFADA also provides a clear pecking order of legal rights for fiduciary access, leaving it to the individual first, then TOSAs, and then other state laws. This puts the power of planning back into the hands of the individual. However, it does require careful planning.

DIGITAL ASSETS REPRESENT BOTH TREMENDOUS PLANNING CHALLENGES AND A UNIQUE PLANNING OPPORTUNITY.

Because it requires proactive planning, financial services professionals have a unique opportunity to help their clients and prospective clients by engaging them on the topic of digital asset planning. Because states often make slight modifications to uniform laws, it is always important to talk to an estate planning attorney in the state in question when setting up a digital asset plan. The language used in each state could vary as do other requirements for wills, trusts, and powers of attorney. Best planning techniques today still require the individual to track his or her digital assets and account access information, and to provide some direction as to the individual's wishes with regard to the future disposition of the assets. The final, but not least, best planning technique is to set up all the estate planning fiduciary documents to specifically address digital asset access.



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Life Insurance Planning

Enhancing Creditor Protection for Life Insurance

By Eva Stark, JD, LL.M.

Certain common assets owned by many households may enjoy a heightened level of protection under a state's statutory exemption scheme. The most prominent assets that are typically sheltered to some degree by statute include equity in one's home, qualified and tax advantaged retirement plans, annuities and life insurance. Because life insurance is such a crucial tool to protect the income needs of a family, and can also serve as a valuable accumulation tool for savings, it is vital to understand the extent to which protection may be afforded, as well as planning options to enhance protection that is lacking.

STATE-SPECIFIC EXEMPTIONS VARY GREATLY

When analyzing a life insurance policy for creditor protection purposes, an initial element of the analysis is to identify the debtor, as well as the other the parties to the contract.

- In New York, for example, a life insurance policy is not protected if the beneficiary is anyone other than the owner's spouse.
- Some states differentiate between the creditors of the insured and the beneficiary—e.g., Washington, may provide protection only if the beneficiary of the policy is someone other than the insured.

A second key element is determining what part (or parts) of the policy is protected, and to what extent. Some states may only exempt the death benefit of a policy, while others exempt the cash value; still others may exempt the cash value but only to a certain extent.

- For example, in Colorado, the cash value of a policy is generally exempt, but only up to $50,000.
- In Kansas, all of the cash value of a life insurance policy may be exempt if certain conditions are present.

The history of the policy may also influence whether it will be afforded creditor protection.

- In Massachusetts, the entire cash surrender value of a life insurance policy is exempt only if the beneficiary remains unchanged since the policy was first issued and the beneficiary has an insurable interest in the insured.
- In Iowa, the protection afforded to cash value is limited to $10,000 in the first two years the policy is in force.

Potential ambiguities in statutes adds a layer of uncertainty, often due to confusing drafting.

- In California, matured life insurance policies are exempt from creditors, but only to the extent reasonably necessary for the support of the debtor, his/her spouse, and dependents. The words reasonably necessary are vague and provide little assurance as it is typically analyzed on a facts-and-circumstances basis which could result in significantly different outcomes. Other ambiguities may exist where the husband and wife may both be debtors or in case of non-traditional insurance products.

And, if a client moves to another state, the analysis has to begin all over again.

ENHANCING PROTECTION WITH AN ILIT

Although life insurance is a "favored" asset in that it is generally afforded some degree of protection most other assets do not enjoy, protection of life insurance policies can be made much stronger by creating an irrevocable life insurance trust (ILIT):

- Once assets are transferred to an ILIT, they will generally be protected from the transferor's creditors, provided that the transfer is not a fraudulent transfer or a scheme to defraud creditors (an argument that can generally be avoided if the ILIT is created before creditor issues arise).
- ILIT owned life insurance may avoid federal and/or state estate tax.
- An ILIT can protect policy proceeds for the lifetime of a beneficiary—even generations.
- An ILIT can provide for professional management of insurance proceeds, and ensure that funds are preserved and spent in a prudent manner.

CONCLUSION

While funds invested in a life insurance policy may be protected from creditors to varying degrees under state law, an ILIT can offer an enhanced level of protection that even the most debtor-friendly states may not provide.

Clients should consider discussing with a trusted financial advisor, insurance professional, and/or attorney whether an ILIT would be a good tool to protect life insurance policies they have purchased to protect their family.

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Estate planning

Revoking the irrevocable.

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

Irrevocable life insurance trusts (ILITs) are useful and powerful tools, and have been a staple of estate and asset protection planning for quite some time; however, as laws and personal circumstances continue to change with each passing decade, those once cutting-edge ILITs drafted in years past may not be serving the objectives that inspired their creation, and clients may want to essentially revoke the irrevocable. Fortunately, there are viable options to do this without triggering adverse tax results.

Reviewing ILIT objectives, purpose.

Ascertain how the ILIT is no longer serving the client's needs, as updated planning may determine the best course of action to effect a modification. The most common reasons for modifying an existing arrangement include:

- Financial wherewithal to maintain policy premiums or long term viability of the policy.
- Diminished perceived benefits due to changes in the transfer tax laws.
- Identity of desired trust beneficiaries due to marital status changes or family strife.
- Concerns over early distributions/termination to trust beneficiaries.

Potential options to modify.

- **POLICY SALE.**
  Because the trustee of the ILIT owes a fiduciary duty to the beneficiaries, a trustee may not generally effect a distribution of a policy directly to the non-beneficiary insured. For a trust that no longer meets the insured's planning objectives, the trustee may generally sell the policy to the insured for the fair market value of the policy.
- **TRUSTEE'S DISCRETION TO TERMINATE/DISTRIBUTE.**
  Often, provisions exist that permit the trustee to terminate a trust based upon its size or the inherent administrative burdens relative to the benefits remaining. Also, depending on the express terms of the document, the trustee may employ liberal discretion to distribute principal or income outright.
- **POWERS OF APPOINTMENT.**
  Conversely, provisions may permit a trustee or beneficiary to employ a limited power of appointment of trust assets, offering a way to direct assets to specific beneficiaries or a trust with more current distribution, tax, and asset protection provisions.
- **TRUST PROTECTORS.**
  More recent ILITs may have provisions that permit modification of the trust language based on changed circumstances, tax laws, or a beneficiary's specific situation. For example, a trust protector using his or her appointed power may modify the trust language to include a special needs trust provision in anticipation of distributions for disabled beneficiaries.
- **TRUST DECANTING.**
  Some states have recently provided a helping hand to modify a trust arrangement in the form of decanting statutes that provide a structure to move assets from older ILITs with insufficient or imperfect language to new trusts with language specifically addressing new tax laws or changed circumstances. Decanting may be especially helpful to address

beneficiary distribution issues, such as when an overly strict or liberal ILIT distribution provisions are not appropriate or too restrictive for a given beneficiary.

- **JUDICIAL REFORMATION.** Of course, as a last resort, the ability to petition a court of law to modify or terminate an ILIT may be available under state law; however, depending on the jurisdiction and the sophistication level of the local judges regarding trust matters, the cost and probability of success of doing so vary somewhat. Typically, if all parties to the termination or modification agree, a court may acquiesce to a termination or modification, but a single dissenting voice can increase costs and unpredictability as to the outcome.
- Additionally, a judicial reformation of a trust can give rise to unintended tax consequences, as the IRS has stated that it will generally not be bound by a reformation for tax purposes.

As in all situations involving a potential modification to an otherwise irrevocable trust, a visit with an experienced estate planning attorney in the applicable jurisdiction to discuss the reasons for seeking to alter an arrangement and review potential planning options is always of paramount importance.

David R. Toups, JD, MBA, CFA®, CFP®, CTFA, joined The Nautilus Group in 2016 after more than fourteen years in the private practice of law focused in estate, trust, guardianship, and business planning and litigation. Prior to practicing law, he managed money professionally as an investment portfolio manager for several national corporate fiduciaries. As a member of the case development team, David contributes his training and experience in the analysis and explanation of multi-faceted estate, trust, and business planning strategies. He earned his BBA in marketing from Texas A&M; his MBA, with a finance emphasis, from Sam Houston State; and his JD, with honors, from South Texas College of Law. David is also a former U.S. Marine Corps artillery and infantry officer.