FALL 2019

For Trusted Advisors

NEW YORK LIFE

Estate planning in a rising interest rate environment.

By Eva Stark, JD, LL.M.

Interest rates have been gradually rising in recent months and additional interest rate hikes are anticipated.

	September 2016	September 2017	September 2018
Short-Term AFR (annual)	0.61%	1.29%	2.51%
Mid-Term AFR (annual)	1.22%	1.94%	2.86%
Long-Term AFR (annual)	1.90%	2.60%	3.02%
Section 7520 rate	1.40%	2.40%	3.40%

Rising interest rates

Rising interest rates could impact the benefit that certain estate planning strategies provide to high net worth individuals from a transfer tax perspective. A wide variety of wealth transfer techniques involve split-interest gifts or similar strategies whose potency is heavily dependent on prevailing interest rates—most commonly the applicable federal rate (AFR) or the rate prescribed in the Internal Revenue Code Section 7520 (7520 rate).

While the effectiveness of some strategies will suffer as interest rates rise, other, long-forgotten strategies, may become more effective.

Techniques that suffer from rising interest rates

INTRA-FAMILY LOANS: With an intra-family loan, the senior generation transfers funds to the younger generation in exchange for a properly documented promissory note. For the IRS to respect the transfer as a loan and to avoid gift tax implications, the note must generally bear adequate interest at the AFR. If the growth rate of the assets transferred outperforms the AFR, any appreciation in excess of the AFR constitutes a gift-tax free transfer from the senior generation to the younger generation.

This technique works best when interest rates are lower as it allows for the transfer of more appreciation gift-tax free. As interest rates rise, the potential for a tax-free gift is reduced.

INTENTIONALLY DEFECTIVE GRANTOR TRUST INSTALLMENT SALE: In an installment sale to an intentionally defective grantor trust (IDGT), the senior generation sells an appreciating asset to a grantor trust for the benefit of the younger generation in exchange for a promissory note bearing interest at the AFR.

To help ensure that the sale is respected by the IRS, the grantor also makes a "seed gift" to the trust, typically equal to at least 10% of the value of the asset that is to be sold to the trust. Because the trust is structured as a grantor trust, generally no gain is triggered when the grantor sells the asset to the trust and no taxable interest is generated when the grantor receives interest payments with respect to the promissory note. If the asset sold to the trust appreciates at a rate in excess of the AFR, the excess appreciation is effectively transferred gift-tax free.

As with intra-family loans, this technique works best when interest rates are lower as it allows for the transfer of more appreciation gift-tax free. As interest rates rise, the potential for a tax-free gift is reduced.

GRANTOR RETAINED ANNUITY TRUSTS: With a grantor retained annuity trust (GRAT), the grantor transfers assets to a trust and the trust pays the

grantor an annuity for a fixed number of years. At the end of the annuity term, assets pass for the benefit of the younger generation, provided that the grantor survives the term of the trust. The difference between the value of the assets transferred to the trust and the present value of the annuity payable to the grantor constitutes a taxable gift; however, most GRATs are structured to "zero-out" and result in little to no taxable gift. The present value of the grantor's annuity interest takes into account the 7520 rate, which results in a larger annuity interest when interest rates are lower (resulting in a smaller gift) and a smaller annuity interest when interest rates are higher (resulting in a larger gift), all other things being equal. If the investments in the GRAT outperform the 7520 rate, a successful tax-free gift is made to the younger generation.

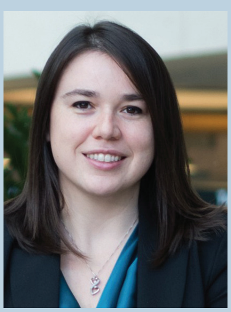
CHARITABLE LEAD ANNUITY TRUSTS: With a charitable lead annuity trust (CLAT) the grantor transfers assets to a charitable trust. During the term of the trust, annuity payments are made to charity. At the end of the annuity term payable to charity, the remaining assets pass to the grantor's non-charitable beneficiaries. The present value of the annuity takes into account the 7520 rate. The difference between the value of the asset transferred to the trust and the present value of the annuity constitutes a taxable gift; however, CLATs are often structured so that the value of the gift is zero or near zero. As with GRATs, a lower 7520 rate results in a larger annuity interest for the charity and a higher 7520 rate results in a smaller annuity interest for the charity, all other things being equal. If the investments in the CLAT outperform the 7520 rate, a successful tax-free gift is made to the younger generation.

Techniques that benefit from rising interest rates

QUALIFIED PERSONAL RESIDENCE TRUSTS: With a qualified personal residence trust (QPRT), the grantor transfers his or her personal residence (or vacation home) to a trust. The grantor retains the right to continue living in the property for a term of years, and at the end of the term, the grantor must vacate the property or pay fair market value rent. At the end of the QPRT's term, trust assets transfer to the younger generation provided that the grantor survives the term of the trust. The difference between the value of the residence and the present value of the grantor's retained right to live in the residence constitutes a gift to the younger generation. The value of the grantor's retained interest takes into account the 7520 rate. A higher 7520 rate will result in a higher value for the retained right to utilize the residence and a lower taxable gift to the remainder beneficiaries, all other things being equal.

CHARITABLE REMAINDER ANNUITY TRUSTS: With a charitable remainder annuity trust (CRAT), the grantor transfers property to a trust and receives an annuity. At the end of the annuity term, the remaining trust assets pass to charity. When making a transfer to a CRAT, the grantor is generally entitled to a charitable income tax deduction equal to the value of the charitable gift. The value of the charitable gift is the difference between the value of the assets contributed to the CRAT and the value of the annuity interest retained by the grantor. The value of the grantor's retained annuity interest takes into account the 7520 rate. With a higher 7520 rate, the present value of the grantor's retained interest will decrease and the value of the remainder charitable gift will increase, resulting in a higher income tax deduction, all other things being equal.

While interest rates have been rising and are anticipated to increase further, they are still near historic lows. As a result, the present may be an opportune time to lock in wealth transfer strategies that benefit from lower interest rates. It may also be a good opportunity to evaluate estate plans with advisors and explore long forgotten strategies that may become increasingly effective as interest rates continue to increase.



Eva Stark, JD, LL.M.

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Estate Planning

Estate planning today: Beyond estate taxes.

By Ari Marin, JD, LL.M., CFP®, CLU®

Despite the changes introduced by the Tax Cuts and Jobs Act of 2017, tried and true estate planning strategies centered on federal estate tax mitigation continue to be a focal point for ultra-high net worth clients. For wealthy households that are under the current combined federal exemption level, however, the de-emphasis of estate tax planning has not obviated the need for concerted planning nonetheless. In fact, many crucial planning needs can be overlooked or ignored if estate planning is viewed largely as a rote exercise in tax mitigation.

Multifaceted tax planning for estates

Estate planning is frequently viewed as the conservation and distribution of wealth according to the owner's objectives in a tax efficient manner. Estate planning should furthermore address threats to wealth on multiple tax fronts. While several states impose a state level death tax, the larger tax priority for many individuals involves income tax planning. As a result, trust arrangements that are very common under traditional estate tax-focused estate plans should be reviewed with respect to income tax efficiency. For example:

- Large IRAs and qualified plans passing to children and/or further descendants can continue to maximize tax deferral based on the beneficiaries' own life expectancies. However, if a trust is named as a beneficiary of such account, optimal tax deferral may not be available. Conversely, a beneficiary receiving proceeds from a plan directly may elect to withdraw all funds and trigger taxes at a much higher marginal rate. In such circumstance, a properly designed and designated trust may be more appropriate.
- For closely held business interests passing under a common estate tax savings trust, trust ownership should not otherwise interfere with an S election, eligibility for the qualified business income tax deduction, or subject business income to higher income taxation than is necessary.
- State income taxation can also arise (or potentially be avoided) depending on a variety of factors, including: situs of a trust (applicable state law), domicile of trustee, and domicile of beneficiaries.
- It may be necessary to weigh the income tax savings of mandatory distributions of income (common under many trust arrangements) with the suitability of such distributions from an incentive and creditor protection standpoint. Income accumulated inside a trust is generally subject to compressed income tax brackets, resulting in a higher effective income tax rate. Trust income distributed to a beneficiary may be taxed at a beneficiary's lower income tax rate but may also be counterproductive if such distributions would be misspent or claimed by creditors.

Need for flexibility

Flexibility is the hallmark of modern plans. Although one's estate planning documents (wills, trusts, power of attorney documents, living wills, etc.) should be updated regularly to reflect the current legal environment,

additional tools are available to provide sensible modifications to documents that can no longer be changed.

Inclusion of trust modification provisions, disclaimer planning, decanting, the possibility of state sanctioned modification agreements, or the appointment of special fiduciaries can ensure that the estate plan can adapt after implementation or after death to account for changes in the law, objectives, family circumstances and dynamics.

For example, disclaimer trust planning offers a "wait and see" approach to trust planning for married couples. Upon the death of the first spouse to die, a qualified disclaimer can be exercised to shift all or part of assets from the originally intended person or trust to another.

Circumstances that may merit a disclaimer would include asset protection, estate tax planning, and/or income tax basis planning.

Wealth Distribution Planning

Hazards to wealth may also stem from beneficiaries themselves. Potential creditors, spendthrift habits, anti-social behavior and divorce can all pose a greater threat to one's wealth than taxes. Even with the best of intentions, the mismanagement of trust property can quickly erode the wealth a family has taken a lifetime to create. Modern plans may incorporate safeguards to such occurrences without imposing excessive rigidity.

- For example, "directed trusts" incorporate trust advisors and distribution committees to bifurcate and oversee some of the traditional functions of the trustee.
- An appointed trust protector can, amongst other powers, veto trust distributions, settle disputes between co-trustees, oversee and hire/fire a trustee and increase/decrease the interest of any beneficiaries of the trust.

The increasing prevalence of blended families can make estate planning more complex. For example:

- While many states' laws automatically revoke a will with respect to dispositions to a former spouse, some do not, and those which do may not remove former in-laws from being appointed as fiduciaries and/or receiving an inheritance.
- A simple all-to-spouse will can result in the disinheritance of children of the first spouse to die. Conversely, failure to provide for a spouse can result in a challenge under spousal elective share laws.
- Planning around the spousal election may be crucial in these contexts, which can include a formal waiver of the election by the spouse or use of a qualified terminal interest property trust

for his or her benefit. To the extent assets are left in trust, appointing a professional trustee such as a bank or trust company to oversee the management of a trust may be the best practice to reduce family friction.

- Lastly, because individuals not otherwise bound by a blood relation may be even more prone to rancorous will contests, probate avoidance through the use of a revocable living trust may be critical.

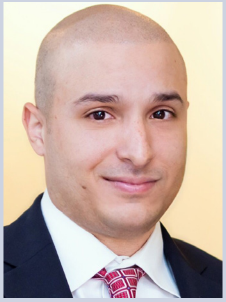
Liquidity Planning

Although the life insurance discussion usually begins with the establishment of a specific insurance need, certain products offer benefits beyond death protection, and can therefore address multiple planning needs simultaneously. While life insurance death proceeds are generally received by the beneficiary income tax free, permanent products offer tax deferred growth (and potentially tax preferred access) on cash values that can act as a buffer in a turbulent market. Additionally, cash values and death proceeds may be exempt from creditor claims under state exemption laws, though such laws vary dramatically from state to state. Trust planning can enhance creditor protection regardless of the jurisdiction, while access to cash value can be preserved through techniques such as loan arrangements and spousal lifetime access trusts.

Additionally, certain life products offer additional long-term benefits and protection in the event a need arises for a policy owner in the future. Of course, life insurance is also oftentimes necessary as a wealth creation vehicle to mitigate against the estate dilution effects of a large and growing family and to support fair and equal allocation of inheritances.

Conclusion

While estate tax laws are constantly changing, the priorities involved in planning an estate should be viewed holistically and designed to meet the unique needs of a family's specific situation. Furthermore, a truly comprehensive plan requires coordination with all advisors, as no single discipline has the expertise to adequately address every facet of an estate plan. As General Dwight D. Eisenhower once said, "plans themselves are useless, but planning is essential."



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Special Needs Planning

Planning for incapacity or disability.

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

As people grow older and, hopefully, wiser, their mortality becomes a more frequent consideration, and estate planning takes on an ever-increasing importance. Modern medicine and healthier lifestyles have greatly contributed to Americans living longer than ever before. Diseases and infirmities that previously ended lives in prior generations are now remedied or treated; however, those remedies and treatments that prevent a fatality are increasingly resulting in incapacity or disability instead.

In our fast-paced life in the United States, younger adults rarely consider their own mortality, much less the possibility of disability or incapacity. Unfortunately, for younger adults, the likelihood of being disabled or incapacitated greatly exceeds their chance of dying. Individuals in their 30s are three to four times more likely to be disabled than to die, and those in their 40s are over twice as likely to be disabled than die. Failing to plan for incapacity or disability can prove costly without the provisions and structures designed to handle such a contingency.

As a legal foundation for capacity planning, the law in the United States presumes the capacity of an individual upon their 18th birthday and all of the rights recognized in the Constitution spring into effect at that time. Restricting or limiting any of those rights requires affirmative legal action to do so. A guardianship or conservatorship proceeding is such an action, and it seeks to restrict or limit those rights for the good or benefit of an individual alleged to be incapacitated.

Similarly, just as the law presumes capacity at 18, the law presumes incapacity for minors. Even though a teenager may demonstrate a maturity exceeding most 30-year-olds, the law draws a bright-line rule and until the age of majority, without an emancipation proceeding, minors may not represent themselves in court, have contractual agreements enforced against them, or receive medical treatment without parental consent.

Whether it's for mental incapacity, physical disability, or legal agency, capacity planning comprises an import part of a solid estate plan.

The following documents can help to address certain needs that arise when incapacity or disability strikes.

Power of Attorney

A power of attorney is a legal document which permits a person to designate or name another person to act on his or her behalf as an agent. The powers granted to the agent can be broad or very narrow, for as long as the principal indicates, up until the principal's death. The power of attorney can be made durable, which means that the named agent(s) may continue to act for the principal even if the principal has become incapacitated.

For capacity planning purposes, a durable power of attorney permits the agent to act for the principal, but the document does not remove the principal's ability to act. It is a great tool to help avoid costly guardianship proceedings since someone can conduct the personal and business affairs of the principal without having a guardian appointed. However, if the principal is suffering with an impairment that waxes and wanes, such as mild Alzheimer's disease, and third parties would not be aware that the person is incapacitated when doing business with them, a guardianship may be needed to remove the principal's ability to act.

At the time of execution, the principal must have capacity to execute and name agents to act on his or her behalf. A person without capacity may be able to physically sign his name on a document but, without capacity, legally the document is invalid. Also, if the persons assisting or inducing the power of attorney to be signed know that the person is incapacitated, they may be liable for their actions. Additionally, for entrepreneurs and executives who have built companies and established business holdings, a business succession plan should contain a specific power of attorney for business decisions naming agents capable of managing those holdings if the other business succession plan documents do not specifically address such an event or contingency.

Medical Powers of Attorney

A medical power of attorney is a power of attorney that is specifically structured to address health care decisions. The principal names agents to act on his or her behalf regarding medical treatment and services to be provided in the event the principal is unable to provide the direction.

From a legal perspective, patients provide consent to physicians to perform medical examinations and procedures; otherwise, the procedure would constitute a battery for which the doctor could be liable. Assumed in the interactions performed in hospitals and doctors' offices daily is the capacity of the patient to consent. Absent capacity, a patient cannot provide the necessary consent for the doctor or provider to perform the medical procedure or service.

Without a durable medical power of attorney, upon incapacity, a guardianship may need to commence in order to designate someone who may consent to medical services and treatments for that person.

Revocable Trusts

Trusts often prove to be a useful tool for capacity planning, especially when the grantor's holdings and properties are plentiful, diverse, or exist in more than one state. For single entrepreneurs, if your next drive on the highway results in an accident, leaving you incapacitated, the likelihood that your friends or family know all of the places you have businesses, accounts, policies, properties, or holdings is rather remote and exceptionally unusual.

A trust is the separation of legal and equitable title to property recognized under the law. A revocable trust permits the creator or grantor the ability to amend or revoke the trust after its creation. When properly funded with the grantor's assets, it functions as a convenient treasure house for his or her holdings. A grantor typically names himself or herself as trustee, who manages and administers the assets in the trust. Additionally, the grantor typically appoints successor trustees to act. Upon the grantor's disability, the successor trustee can immediately step in with authority to act, provide direction, and care for the incapacitated grantor. Property located out of state, if properly transferred to the trust, would not require legal proceedings to transfer or administer the assets. Additionally, the nature and extent of the assets and holdings would not be subject to public disclosure, which may occur if guardianship or conservatorship proceedings related to the estate had to commence.

Designation of Guardians or Conservators

Certain states provide statutory legal forms that may be used to designate a guardian or conservator in the event one is necessary. These documents should be executed as part of an overall estate plan. If the document proves unnecessary, the cost of its preparation should be negligible; however, if the need arises for a guardian, it prevents a problematic child or greedy relative from serving as guardian or conservator or subjecting the estate to litigation to become guardian or conservator over others more deserving. Some estate planning attorneys include language in their client's powers of attorney indicating that certain named agents should serve as guardian or conservator if such proceedings were to commence. In some states, the filing of a guardianship or conservatorship proceeding suspends the powers of designated agents under a durable power of attorney, which may lead to gamesmanship as attorneys jockey to have their client appointed as guardian or conservator of the estate.

Guardianship or Conservatorship

If no planning exists or circumstances require it, a guardianship or conservatorship proceeding may commence for the incapacitated person. A court of law must determine if the person is incapacitated and, if so, what powers the guardian or conservator may exercise in his or her best interest. The court provides oversight of the guardian or conservator, often with periodic reporting back to the court regarding the health and status of the incapacitated person or his or her estate. Without capacity planning documents, strangers determine who will serve as guardian or conservator of the incapacitated person and his or her estate. Since legal proceedings and oversight exist, the cost associated with guardianship or conservatorship proceedings rise quickly. Also, entrepreneurs serve as the foremost experts on how to operate, manage, and profitably conduct their businesses and properties, but if the entrepreneur fails to designate anyone to serve in his or her place, a judge without the benefit of such knowledge and experience does so—often with far less favorable results to the estate.

The necessity of an effective capacity plan is directly proportional to the uniqueness and size of a person's estate and holdings. As the number of persons able to effectively manage and administer a person's assets decrease, the importance of creating a succession plan in the event of the principal's incapacity becomes critical; otherwise, the losses resulting from delay, indecision, or mismanagement may prove devastating, leaving the incapacitated person and their loved ones in an economic state far below that previously enjoyed.

Discussing capacity planning and other available planning alternatives with a trusted financial advisor may prove to be the wisest action you take this year.

David R. Toups, JD, MBA, CFA®, CFP®, CTFA, joined The Nautilus Group in 2016 after more than 14 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. 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 a former U.S. Marine Corps artillery and infantry officer.