WRMarketplace

An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Administration's FY 2016 Budget- Part I: Something Old, Something New (with Sample Client Letter).

MARKET TREND: As previewed in the President's recent State of the Union address, the Administration continues to focus on the estate and income taxation of higher income taxpayers, both by renewing prior budget proposals and introducing new ones that directly target the estates and income of high net worth individuals ("HNWIs").

SYNOPSIS: With regard to life insurance and individual tax reform, the Administration's FY 2016 Budget mostly renews proposals from past budgets, with a few exceptions.

- **Life Insurance Reform:** Notable, renewed proposals include: (1) the expansion of the interest deduction limitations related to COLI policies; (2) modification of the dividends received deduction for life insurers; (3) limits to the exceptions to the transfer for value rule for life settlements; and (4) specific information reporting requirements for life settlements.

- **Individual Reform:** Notable proposals include: (1) an increase in the top capital gains rate to 24.2%; (2) application of capital gains tax on appreciation in assets upon transfer by gift or bequest; (3) limits on certain deductions for taxpayers in the top income tax brackets; (4) imposition of a 30% "Fair Share Tax" on HNWIs; (5) imposition of a 10-year minimum term and greater of 25% or $500,000 minimum remainder for GRATs.

TAKE AWAYS: As with past budgets, the FY 2016 Budget only represents the Administration's proposals for future tax legislation, none of which can take effect without Congressional action. It is uncertain whether Congress will even consider, much less pass, any of these proposals in their current form. The budget provides another opportunity for advisors and their clients to examine existing planning techniques and options, future needs, and the use and benefits of life insurance products. As budget proposals would have dramatic effects, if enacted, AALU will ensure its continued monitoring of legislative activity and interaction with those who will craft any pertinent tax reform legislation.

PRIOR WRM REPORTS: *15-03; 14-11; 14-10; 13-16.*

MAJOR REFERENCES: *Budget of the U.S. Government Fiscal Year 2016; General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (Feb. 2015).*

The Obama Administration's federal budget for fiscal year 2016, as explained in the Treasury's General Explanations of the Administration's Revenue Proposals ("**2016 budget**" or "**budget**"), renews many prior budget proposals, with some new twists. As most of the noteworthy proposals have been summarized in recent Washington Reports and materials (e.g., *WRMarketplace No. 15-03; AALU's Summary of Select Proposals in the Administration's Fiscal Year 2016 Budget ("Summary")),* this Part I provides additional detail and commentary on the notable provisions that, if enacted, could significantly impact life insurance, income, and transfer tax planning. Proposals affecting employee benefits and retirement planning will be reviewed in Part II.

LIFE INSURANCE PROPOSALS

The 2016 budget renews many of the Administration's previous budget proposals with minimal changes, including the following:

Expanded Interest Deduction Limits for COLI Policies. Corporations currently cannot deduct interest on loans to purchase or carry one or more life insurance policies covering the life of any individual—subject to a de minimus key person exception.[1] In addition, current law contains a pro-rata limit on interest deductions related to the unborrowed cash value of policies covering those other than someone who, when first insured, was an officer, director, employee or 20% owner of the business.[2] The 2016 budget would limit this exclusion of COLI policies to only those COLI policies insuring 20% owners. The proposal would be effective for policies issued after December 31, 2015, and to existing policies materially modified after that date.

> ***Practical Insight***. As noted and discussed in greater detail in *WRMarketplace #14-10* and *WRNewswire #14.02.27*, this proposal effectively operates as a tax penalty to businesses owning life insurance by indirectly taxing the inside build-up of COLI policies and increasing the costs to businesses of acquiring cash value policies to insure their key employees, officers, and directors. Enactment would set a negative precedent regarding the tax treatment of life insurance and would have a harmful impact on businesses, jobs, and employee benefits, given the importance of COLI in helping businesses remain in operation after the death of a key owner and employee and in financing and securing employee benefits.

Modified Proration Rules for Determining Insurer's DRD. Corporations, including life insurers, may deduct dividends received from subsidiaries or other domestic corporations to avoid triple taxation (the "dividends received deduction" or "**DRD**"). For life insurance companies, the DRD is limited by the portion of the company's dividend income used to fund tax-deductible reserves for its obligations to policyholders. The budget would replace the methodology used by carriers to determine the DRD and require a separate determination of the DRD deduction limits for a company's general account (supporting non-variable insurance products) and for each separate account (supporting variable policies and annuity contracts).

> ***Practical Insight.*** If enacted, the DRD proposal would disproportionately and adversely impact life insurance companies, potentially increasing the cost and accessibility of life insurance products.

Limited Exceptions to Transfer for Value ("TFV") Rules. Generally, otherwise tax-free death benefits paid under a policy transferred for value are subject to income tax to the extent those proceeds exceed the consideration and subsequent premiums paid by the purchaser ("**TFV rule**"). The TFV rule, however, does not apply to: (1) a transfer of a policy if the transferee's tax basis is determined by reference to the transferor's basis (e.g., a gift), (2) a transfer of a policy to the insured (including the insured's wholly-owned grantor trust), (3) a transfer of a policy to a partner of the insured, or (4) a transfer of a policy to a partnership or corporation in which the insured is a partner or is an officer or shareholder, respectively.

Under the 2016 budget, however, the exceptions to the TFV rule for the transfer of a policy to a partner of the insured or to a partnership or corporation in which the insured is a partner or shareholder/officer would only apply if the insured was a 20% owner of the applicable entity (all other TFV exceptions would remain available). This proposal would apply to the transfer for value of a life insurance policy after December 31, 2015.

> ***Practical Insight.*** While the proposal seeks to limit the availability of TFV exceptions for life settlement transactions (i.e., sales of policies to unrelated, third parties) by providing a 20% ownership test, the potential for overly-broad application could result in taxation of common business planning transactions, such as business-related policy transfers (as in corporate mergers or acquisitions), roll-outs of split dollar arrangements to former employees or owners, buy-sell restructurings, etc.

Tax Information Reporting For Sales of Existing Life Insurance Contracts. The owner of a life insurance policy who sells the policy in a life settlement transaction must report taxable income on the difference between: (1) the amount received and (2) the owner's adjusted basis in the policy (i.e., total premiums and other consideration paid for the policy, minus (based on Rev. Rul. 2009-13) the portion of the premiums allocated to the cost of life insurance protection). The buyer of the policy will incur tax on the difference between the death benefits received and the consideration and subsequent premiums it paid (unless an exception to the TFV rule applies to the settlement).

The 2016 budget would impose special tax information reporting requirements for life settlements of policies with death benefits of $500,000 or more. Upon sale, the buyer would be required to report the purchase price, the buyer's and seller's identity, and the issuer and policy number to: (1) the IRS, (2) the insurance company that issued the policy, and (3) the seller. Upon the payment of policy death benefits, the carrier would be required to report the gross benefit paid, the buyer's identity, and the carrier's estimate of the buyer's basis to the IRS and to the payee.

> ***Practical Insight.*** While this information reporting would allow the IRS to increase compliance and collection efforts with regard to life settlements, it would impose an additional reporting requirement on carriers to track settled policies and the buyer's basis in the policy after settlement. Further, customers purchasing policies might expect their insurance advisors to assist with the preparation and filing of such reports.

Required Information Reporting for Private Separate Accounts. The 2016 budget proposes reporting requirements on life insurers related to the tax-deferred build-up of investments held in private separate accounts of certain life insurance policies. For each policy with cash value invested in a private separate account that represents at least 10% of the value of the account for the taxable year, insurers would need to provide the IRS with the policy holder's identity, the

policy number, the accumulated, untaxed income, the total contract value, and the portion of the account value invested in a private separate account.

> ***Practical Insight.*** Implementation of this proposal could allow the IRS to more closely evaluate private placement variable contracts and, as noted in the 2016 budget, "enable the IRS to identify more easily which variable insurance contracts qualify as insurance contracts under current law and which contracts should be disregarded under the investor control doctrine."

Financial Institution Fee. The budget proposes a seven basis point fee on the "covered liabilities" of large U.S. financial firms with assets over $50 billion (although the fee would be deductible in computing corporate income tax). Covered liabilities are assets less equity for banks and non-banks based on audited financial statements, with a deduction for separate accounts primarily for insurance companies.

> ***Practical Insight.*** Financial institutions, including life insurers, impacted by this fee could pass on the additional expense to customers in the form of higher fees and higher costs for products and services, including life insurance products.

NEW & RENEWED INDIVIDUAL INCOME TAX PROPOSALS

The Administration's new and renewed budget proposals related to individual income taxation are primarily focused on raising income taxes on HNWIs.

Higher Top Capital Gains and Qualified Dividend Rate (*NEW*). Currently, long-term capital gains ("**LTCG**") and qualified dividends are taxed at a top rate of 20% and subject to the 3.8% tax on net investment income ("**NII**"), for a top combined rate of 23.8%. The budget would increase the top LTCG and qualified dividends tax rate to 24.2%, so that, when combined with the 3.8% NII tax, the top effective federal rate would be 28%.

> ***Practical Insight.*** The budget clarifies a point that was unclear in the President's original introduction of this proposal -- that the top 28% rate is inclusive of, and not in addition to, the NII tax. Regardless, this higher rate, particularly when combined with applicable state taxes, would significantly impact HNWIs who have substantial LTCG and dividend income, as well as affect tax planning for sales and acquisitions of business interests. These higher rates could increase interest in a variety of planning options, including annuities, life insurance, and corresponding private placement alternatives for these products.

Capital Gains Tax on Bequests/Gifts of Appreciated Assets (*NEW*). Currently, assets held in a decedent's estate may incur federal estate tax but generally are not subject to current federal capital gains tax when they pass to the decedent's heirs. An heir also typically takes the asset with a "stepped-up" income tax basis equal to its fair market value as of the decedent's date of death.[3] Likewise, when gifts are made, the gift generally does not generate a capital gains tax liability to the donor or the donee. The donee, however, takes a carryover basis in the property for income tax purposes, such that appreciation in the gifted property likely will incur capital gains tax upon a subsequent sale.

As discussed in detail in *WRMarketplace No. 15-03*, the Administration proposes to treat gifts and bequests of appreciated assets as sales of such assets for federal capital gains tax purposes. Capital gains tax would be triggered on the asset appreciation for the year of the transfer (rather than when the recipient later disposes of the property), with the realized capital gains taxable to

the donor or the decedent's estate. Certain exemptions and exclusions would apply, including for gifts and bequests to spouses and charities (see "Summary" for a more detailed discussion).

> ***Practical Insight***. This proposal would dramatically increase the overall tax consequences of gifts and bequests and impose significant liquidity burdens for donees and estates, especially where highly-appreciated, illiquid assets are involved. This liability would be exacerbated by the proposed increase in the top federal LTCG tax rate and by applicable state income or capital gains taxes. For large gifts and estates, the budget envisions an even more substantial, "double" tax hit, since the Administration wants to retain the estate and gift tax but at the higher tax rates and lower exemption levels in effect in 2009 (see below). Enactment of this provision could significantly increase the need for tax and liquidity planning, including through life insurance. However, the proposal would create tremendous practical difficulties regarding finding and keeping records relating to basis. In addition, its departure from long-standing principles of what constitutes a "realization event" in this context could set precedent that could be dangerous to the appropriate tax treatment of various assets (including life insurance) in various contexts.

"Fair Share Tax" (*RENEWED*). The 2016 budget proposes a "Fair Share Tax" ("**FST**") on HNWIs of 30% of adjusted gross income ("**AGI**"), less a credit for charitable contributions. Application of the FST is phased in starting at $1 million of AGI and is fully phased in at $2 million (these thresholds will be subject to inflation indexing). The amount of the FST that would be paid by a HNWI would be the excess of the FST less the sum of: (1) the regular income tax (including the 3.8% NII tax), (2) the alternative minimum tax, and (3) the HNWI's portion of FICA and Medicare tax.

> ***Practical Insight.*** The FST would essentially operate as another alternative minimum tax on HNWIs over the applicable thresholds and would apply in addition to the already higher income tax rates, proposed higher LTCG tax rate, and the 3.8% NII tax, resulting in a minimum federal tax burden of 30% of AGI less charitable contributions. Thus, the FST's enactment could further increase interest in a variety of planning options, including annuities, life insurance, and corresponding private placement alternatives for these products.

Reduced Value for Deductions & Tax Expenditures (*RENEWED*). The 2016 budget proposes to reduce the value to 28% of certain exclusions and deductions that would reduce lessen taxable income in the 33% and higher tax brackets. The income exclusions and deductions affected include: (1) all itemized deductions, (2) any tax-exempt state and local bond interest, (3) employer-sponsored health insurance paid for by employers or with before-tax employee dollars, (4) health insurance costs of self-employed individuals, and (5) employee contributions to defined contribution retirement plans and IRAs. Similar limitations would apply for alternative minimum tax purposes.

> ***Practical Insight.*** The proposal effectively taxes otherwise deductible or excludable items at a rate equal to the difference between the applicable tax bracket and 28%. This amount is significant for top-bracket taxpayers (e.g., taxpayers in the 39.6% bracket would see an 11.6% tax on the value of these items). Enactment of this proposal would minimize long-standing benefits associated with certain employee health and retirement benefits.

Taxation of Carried Interests as Ordinary Income (*RENEWED*). The managers of most hedge funds and private equity funds typically take a profits interest in the funds as a significant part of their compensation (referred to as a "**carried interest**"). If the gains from a fund's underlying assets are LTCG, the managers will be taxed at the LTCG tax rate on the gain

allocated to their carried interest. The 2016 budget seeks to tax some portion of the carried interest at ordinary income rather than LTCG rates (i.e., at a top rate of 39.6% rather than 20%) and to treat some of the gain from the sale or disposition of a carried interest as ordinary income.[4]

> ***Practical Insight.*** Enactment of these or similar proposals would magnify the tax liabilities and liquidity planning needs for fund managers, who may already have significant tax exposure and frequently face liquidity issues, particularly in the early years of a fund. Thus, fund managers will want to stay informed of developments in this area and ensure that their fund documentation takes into account the possibility of change.

RENEWED TRANSFER TAX PROPOSALS

The 2016 budget renews every transfer tax proposal from its FY2015 budget with a few noteworthy tweaks. These renewed proposals include the Administration's desire to:

- **2009 Rates/Exemptions**. Permanently reinstate 2009 transfer tax laws (45% top transfer tax rate; $3.5 million estate and GST tax exemptions, $1 million gift tax exemption), but with portability between spouses.

- **Transfer Taxes on Grantor Trusts**. Coordinate income and estate tax rules for grantor trusts, so that disregarded transactions between a grantor trust and its deemed owner for federal income tax purposes would incur an estate tax (at the deemed owner's death) or a gift tax (upon termination of grantor trust status or on a trust distribution during the deemed owner's life).

- **Minimum Term/Remainder for GRATs**. Require GRATs to have a 10-year minimum term and (***NEW***) a minimum remainder value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed).

- **Expiration of GST Tax Exemption**. Impose a 90-year limit on a trust's GST tax exemption.

- **No GST Tax Benefits for HEETs**. Modify GST taxation of health, education and exclusion trusts ("HEETs") so that the tax exclusion only applies to direct payments by a donor (not a trust) to the provider of medical care or to the school in payment of tuition.

- **New $50,000 Annual Exclusion Category**. Create a new category of annual exclusion gifts with an annual exclusion limit of $50,000 per donor on transfers within this new category (which would include certain transfers in trust, transfers of interests in pass-through entities or that have sale restrictions, etc.). The exclusion would not require the donee (e.g., a trust beneficiary) to have a present interest in the gift.

> ***Practical Insights***. Many of these proposals have appeared in prior years' budgets, but the specification of the amount of the minimum GRAT remainder is new and significant, particularly as GRATs remain a popular wealth transfer planning technique. A 10-year minimum term GRAT eliminates the use of short-term GRATs to hedge against the grantor's mortality risk or a GRAT's poor investment performance. A minimum remainder interest prevents "zeroing-out" the gift made upon the GRAT's creation for gift tax purposes. Both requirements would make the economics of GRAT planning far less attractive.

The proposal for a new annual exclusion category without a present interest requirement, however, is interesting. Depending on the specifics, the proposal, if implemented, could substantially simplify insurance trust funding and eliminate the hassles of providing withdrawal notices (so-called "Crummey" notices) to trust beneficiaries.

TAKE-AWAYS

- As with past budgets, the FY 2016 Budget only represents the Administration's proposals for future tax legislation, none of which can take effect without Congressional action. It is uncertain whether Congress will even consider, much less pass, any of these proposals in their current form.
- The budget provides another opportunity for advisors and their clients to examine existing planning techniques and options, future needs, and the use and benefits of life insurance products.
- As budget proposals would have dramatic effects, if enacted, AALU will ensure its continued monitoring of legislative activity and interaction with those who will craft any pertinent tax reform legislation.

SAMPLE CLIENT LETTER

"Dear Client,

The Obama Administration recently released its federal budget for fiscal year 2016 proposing several tax law changes, which, if enacted, could ***significantly increase your federal income, capital gains and/or estate tax exposure***. Although Congress may not take action on these proposals, they may provide some insight into potential areas of consideration for future tax reform legislation. Some of the more notable proposals include:

- Increasing the top tax rate on long-term capital gains and qualified dividends from ***20% to 24.2%***;
- Making gifts and bequests of appreciated assets "***realization events***" and imposing capital gains tax on the appreciation in the year of the transfer (on top of any gift or estate tax due);
- Imposing a new ***30% "Fair Share Tax"*** on individuals with $1 million or more of adjusted gross income;
- ***Limiting the value*** of certain income tax expenditures and tax deductions (e.g., itemized deductions, employer-paid health insurance, contributions to certain retirement plans and IRAs, etc.) for taxpayers in the 33% or higher income tax brackets;
- Reinstating higher federal estate and gift tax rates (from ***40% to 45%***) and lower exemptions (from $5.43 million for both to ***$3.5 million for estates and $1 million for gifts***); and
- Increasing the ***estate and gift tax costs*** of implementing common wealth transfer planning techniques, including GRATs, sales to grantor trusts, and multi-generational "dynasty" trusts.

Again, the ***budget only represents the Administration's "wish list"*** for future tax legislation. That said, you may wish to review your current estate and income tax planning and consider what options may better serve your overall financial planning needs. We can assist you in this process and help you to lay the groundwork for planning in the event any of these tax proposals becomes a reality.

Please contact us if you have any questions or to schedule a time to discuss these developments and their potential impact."

NOTES

[1] *See* Internal Revenue Code ("**Code**") §§ 264(a)(4) and 264(e).
[2] The pro rata interest disallowance is based on the ratio that the average unborrowed cash values held in COLI policies bears to the sum of (1) those average unborrowed cash values plus (2) the average tax basis of other assets held by the business. *See* Code § 264(f).
[3] Code § 1014.
[4] The 2016 budget also would require the manager to pay self-employment taxes on the earned income (although this may not be significant tax-wise, since passive income would otherwise be subject to the 3.8% NII tax).

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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