

Advanced Sales

Estate planning during times of uncertainty

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ABOUT THE AUTHOR

Dean F. "Chip" Chatlain is an advanced sales consultant for Lincoln Financial Distributors. He has over 40 years of experience as a tax attorney, with more than 35 years in the life insurance industry. His perspectives stem from a solid background in individual and corporate taxation as well as a thorough understanding of the tax advantages of life insurance.

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Chip spent seven years as a trial attorney with the Office of the Chief Counsel for the IRS. Prior to the merger of Lincoln National and Jefferson Pilot, he was corporate tax counsel for the Jefferson Pilot Financial group of companies. He is one of the inventors for the patent issued for the Lincoln *LifeComp*® Suite, which provides illustrations, plan documents and administrative services for business and personal split-dollar arrangements.

Chip has been a member of the Company and Product Tax Committees of the ACLI. He has spoken on numerous occasions at the Forum 400 Annual Meetings, the AALU Annual Meetings, the Clinic for Advanced Professionals of the Society of Financial Service Professionals, the LIMRA Advanced Sales Meetings, and the Federal Bar Association's Insurance Tax Conference.

*Licensed, not practicing.

Overview: Taking action before the election

Americans are not new to adversity. We've been through periods of market and political uncertainty many times before. We've witnessed and weathered challenges, from global health outbreaks to major financial events and their fallout. But over time, the market has consistently performed well regardless of which party won the election or who occupied the White House. Those investors who stayed the course and leaned into market lows — not basing decisions on election results — saw better portfolio results over the long run.

How your clients react to today's environment plays a key role in their ability to reach their long-term goals. So it's more important than ever to take action now — steps toward ensuring your clients' financial plans still mirror their objectives. Now is when you should be communicating at a higher level, reminding clients of the opportunities that times of uncertainty often bring.

We know there are many issues ahead of the November election, and even more pending its outcome. If the Democrats sweep the White House, Senate and House of Representatives, we may see significant increases in both income and estate taxes. The new party in office could push for tax changes retroactive to January 1 — a retroactive effective date means timing is critical for high-net-worth individuals to take action. Waiting until November 4 could make it challenging to implement a wealth transfer strategy by the end of this year.

Remember, if a client's net worth includes hard-to-value assets (such as investment real estate or a closely held business), it's necessary to obtain appraisals before they can be transferred to an irrevocable trust. In fact, it may already be a tight timeline to hire appraisers if clients need appraisals before December 31.

What changes in estate and gift taxes could occur?

The first priority for every ultra-high-net-worth client is to use their entire available lifetime exemption by December 31. This includes reviewing trusts and drafting new ones as necessary. What you should look for is an irrevocable grantor trust that contains swap powers and allows the trustee to make loans to the grantor(s). Remember, the goal is to use all of the lifetime exemption — any unused exemption may be lost.

My preferred strategy right now is to fund an irrevocable grantor trust with a loan equal to the client's current lifetime exemption. Depending on the result of the election, the client can simply forgive the outstanding loans and use their lifetime exemption. An attorney could draft all of the needed documents to implement and execute this strategy well before the election. And, as we know, life insurance is the perfect way to provide estate liquidity to pay estate taxes. So consider adding life insurance as part of your client's funding of their irrevocable trust.

On the campaign trail, many candidates proposed lowering the estate tax lifetime exemption to \$5 million, even as low as \$3.5 million. There is a parallel proposal to tax all unrealized capital gains at the death of the owner. It's possible that both approaches could be blended together. The goal is to have a significant increase in tax revenues and make the transfer taxes more progressive. This makes it imperative that ultra-high-net-worth clients implement plans to use their entire \$11.58 million lifetime exemption before December 31. Remember, if your client uses \$3 million of their \$11.58 million lifetime exemption in December, and the amount of the exemption available in 2021 is only \$3.5 million, the client will only have \$500,000 left to use starting in 2021.

What changes in income taxes could occur?

If the Republicans maintain control of the White House and Senate while the Democrats control the House of Representatives, the emphasis will be to preserve the first term's tax cuts. In addition, there may be proposals to stimulate growth in the economy. We may not see significant changes if Democrats win the White House and Republicans retain control of the Senate.

Now, let's see what may happen on the income tax side if the Democrats sweep the White House, Senate and House of Representatives. First, remember that "wealthy" is a highly subjective term. In 2019, the 75th percentile of household income was about \$113,000. The 90th percentile of household income was

about \$184,000. If you want to raise a few trillion dollars for social programs, you need to start looking at raising the taxes of at least the top 25% of the population.

The Democrat's Unity Task Force has endorsed using income tax laws to address income inequality by making tax rates more progressive. Their recommendations have not gone into detail about which tax changes they want. It's been reported that the progressives want to limit tax-favored savings like 401(k) plans because only people at the upper income level can take advantage of the current salary deferral limits. Advisor Perspectives reports that the full 12.4% Social Security and Medicare taxes may be imposed on all earned income over \$400,000 per year.

The Democrats recently proposed that since most capital gains go to the rich, they want to eliminate the preferential capital gains tax rate. Investors with large unrealized capital gains may start realizing some of those gains in September or October if the Democrats are leading in the polls. Couple that with the potential of higher corporate tax rates for corporations, which could impact equity markets.

Keep your plans on track

If the upcoming election results in a shift of power to the Democrats, lifetime insurance becomes even more attractive to our upper income and high-net-worth clients. **Here are two action items to implement now:**

- 1. First priority** — Individuals may want to consider using their entire life exemption by the end of the year. This means that trusts need to be reviewed or drafted. For maximum flexibility, an irrevocable grantor trust can allow the grantor to access assets in the trust. In order to facilitate using the lifetime exemption this year, the trust could be funded with loans from the grantor. If the Democrats sweep the White House, Senate and House of Representatives, the loan could be forgiven before December 31.
- 2. Second priority** — Identify assets to be transferred to the trust, with preference given to cash and marketable securities. Clients may not have enough time before year-end to obtain appraisals if they have hard-to-value assets, such as a closely held business or investment real estate. Since time is critical, they may want to contact their local banker and borrow enough cash to enable them to contribute their entire lifetime exemption to the trust prior to December 31. Once the appraisals are received, the trust grantor can use the swap power to move the assets into the trust in exchange for the cash. The grantor will then use the cash to repay the lender.

Integrate life insurance into income and estate tax planning for the new environment

- Historically, life insurance has been one of the go-to solutions for liquidity to pay estate taxes after the insured's death. Assets are valued either at date of death, or six months later, with the estate taxes due nine months after death. As 2020 has already shown, the stock market can be volatile, and having cash from a life insurance death benefit in an irrevocable trust protects heirs from having to make a forced sale of assets to pay for estate taxes.
- If unrealized capital gains are taxed at death, then life insurance in an irrevocable trust can be used to provide liquidity on the individual's final income tax return.
- Perhaps the most difficult situation is dealing with someone whose total net worth is a little higher than the current \$11.58 million lifetime exemption. If the exemption is decreased to either \$3.5 million or \$5 million, they will have a significant estate tax liability that under current rules can only be eliminated by putting almost all their assets in an irrevocable trust. For a single person,

the best approach may be to determine the minimum amount of assets they would likely need in the future, and gift the rest. This strategy can be back-stopped by including the ability of the trustee to make unsecured loans to the grantor. For a married couple, serious consideration should be given to using a SLAT (Spousal Lifetime Access Trust). The client should rely on their own legal and tax professionals to avoid the mutual trust doctrine. Factors the client's attorney may consider include timing of the execution of the trusts and differences in the distribution standards to each spouse (loans from the trust versus distributions).

- For clients unwilling or unable to make significant gifts, but who will need additional life insurance to pay increased estate taxes (or income taxes on unrealized appreciation), wealth transfer strategies could be effective, such as (1) sales of assets to irrevocable trusts in exchange for a note due the grantor, (2) private premium financing or private split dollar, (3) Grantor Retained Annuity Trusts (GRATs), or (4) commercial premium financing.

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As we approach the election, it's important to remind clients that the tough times of the past have made us stronger, enabling us to mature as a society, as an economy, and as individuals. Now is the time to encourage clients to be proactive – to take the steps today that will add more opportunity, confidence and certainty for their future.



Work with your financial professional to create plans for your short- and long-term goals.

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