PHILADELPHIA ESTATE PLANNING COUNCIL

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President's Message

Eric Hildenbrand

It is truly an honor to serve as your President for the 81st year of the Philadelphia Estate Planning Council.

As a board member for multiple years, I have had the privilege to experience great leadership from our Presidents, and this past year was no exception. I want to thank immediate Past President, Andrew Haas, for steering our council through arguably our most challenging time in recent memory. It is only fitting that I write my first President's Message from my home as we all continue to navigate this new post-Covid world. I would have thought you were crazy if you told me at the beginning of this year that we would still be holding our luncheon programs virtually!

Given this environment, I am very proud of the way we have been able to adapt our programming, committee meetings, and networking to a virtual setting while still delivering the high-quality content our members have come to expect.

This coming year will undoubtedly prove challenging as well as we look to schedule in-person programming once again. Despite the added comfort and convenience we all have behind the computer screen, nothing takes the place of our luncheon programs at the Union League. Assuming case counts remain steady or continue to decrease, and new vaccinations and therapeutics become available, I am hopeful I will have the opportunity to address our council in-person, standing behind the podium in Lincoln Hall. While we are all highly anticipating our in-person "re-open," please know that our board takes our members' safety very seriously and we continue to monitor the COVID-19 situation closely.

I am thankful for the impressive board behind me, and feel fortunate to have these members, especially those on the executive committee, to help lead us through this program year and beyond. The executive committee is as follows:

- Vice President: James Revels, CPA, MST, AEP – KPMG LLP
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- Immediate Past President: Andrew Haas, Esq. – Blank Rome LLP

As I reflect on the decade I have spent as a member, I think about the benefits I have personally received over the years. From the nationally recognized speakers to the engaging roundtable meetings and newsletters, there are many reasons to be a member. Behind all those activities are our committees. To that end, I can't recommend enough getting involved

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Decanting as an Estate Planning Tool under Pennsylvania Law

Samantha Heaton, Esquire

"Decanting" is a term used to describe the distribution of trust property from one "trust" to another pursuant to a trustee's discretionary power to make distributions to or for the benefit of one or more beneficiaries of the original trust. The concept is comparable to pouring a bottle of wine from one container to another. In the trust context, decanting can be a useful tool for many purposes, including the transfer of the principal of one irrevocable trust to another when the second trust has more favorable terms; to remove a beneficiary from having an interest in a trust when it is no longer desirable for that beneficiary to have such an interest; or to move the assets of the first trust to a second trust with different tax attributes.

Many states allow by statute the decanting of trust principal from one trust

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UPCOMING EVENTS

2021 PROGRAMS

Holiday Celebration
Thursday, December 2, 2021
5:30 – 7:30 p.m.
The Olde Bar
125 Walnut Street
Philadelphia, PA 19106

January In-Person Luncheon Program
Tuesday, January 18, 2022
Watch for more information soon!
Speaker: Mark R. Parthemer, TIAA

February In-Person Luncheon Program
Tuesday, February 15, 2022
"Straddling the Border: Planning for Decedents with Canadian Real Estate, Beneficiaries, and Decision-Makers"
Speaker: Cheyenne Reese, Legacy Tax + Trust Lawyers

March In-Person Luncheon Program
Tuesday, March 15, 2022
Watch for more information soon!

Please register at www.philaepc.org.

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President's Message *continued*

in our very active council committees. All members are welcome to participate on our committees and I can tell you that doing so immediately impacted my professional growth by opening new relationships. The council website contains a list of all the committees and the contact information for the chairs. I encourage everyone to get involved.

As I write this today, we have already had two excellent luncheon speakers this council year: Jere Doyle of BNY Mellon speaking about Distributable Net Income and Michael Amoia of Crump with a very timely presentation on the use of life insurance in an ever-changing tax and estate landscape. I am very excited about the remainder of our program topics leading up to our annual meeting in May 2022. Our last program in 2021 will focus on choosing your philanthropic path and the differences between private foundations and donor advised funds. The first three luncheon speakers in 2022 will focus on the tax and non-tax consequences of choices often buried in boilerplate provisions, international estate planning issues with Canadian assets, beneficiaries or fiduciaries, and lastly an economic overview lead by the head Economist from KPMG. I am also very pleased to have Chris Hoyt as our speaker at our annual meeting. Chris will focus his program on retirement planning. As we know, there have been many recent changes in this area and we are very fortunate to have Chris provide his insight.

I want to thank all our members for their continued support of our great council, and I look forward to seeing you all along the way, whether virtually or, better yet, in person!

Sincerely,
Eric Hildenbrand, CFA

Decanting *continued*

to another. Unfortunately, Pennsylvania does not have such a statute, nor is decanting explicitly permitted at common law. Nevertheless, a trustee of a Pennsylvania trust can achieve similar results under authority of the Pennsylvania Uniform Trust Act (the "Act") through a trust modification, or pursuant to the trust instrument itself. In other words, while decanting is not provided for by statute or common law, a similar result can be achieved through modification under the Act.

The Pennsylvania Uniform Trust Act

Pennsylvania adopted the Act effective November 6, 2006. Unless the terms of a trust provide otherwise, the Act applies to irrevocable trusts created by persons domiciled in Pennsylvania. The Act allows for modifications of irrevocable trusts, both without court approval and with court approval, for various reasons, many of which are similar to the reasons for decanting a trust.

Without Court Approval

Under the Act, all beneficiaries and trustees of a trust may enter a binding nonjudicial settlement agreement ("NJSA") with respect to any matter involving the trust, including the modification or termination of a trust. An NJSA entered into by all beneficiaries and the trustees is valid only to the extent it is not inconsistent with a material purpose of the trust and includes terms and conditions that could be properly approved by a court under the Act.

However, while the settlor of an irrevocable trust is living, a noncharitable irrevocable trust may be modified or terminated through an NJSA upon consent of the settlor and all beneficiaries even if the modification or termination is inconsistent with a material purpose of the trust. If the trust is so terminated, then, upon termination of the trust, the trustee must distribute the trust property as agreed by the beneficiaries.

In addition, a trustee of a trust may terminate the trust if the trustee concludes that the value of the trust property is insufficient to justify the cost of administration, the trustee has given written notice to the "qualified beneficiaries" at least 60 days before the proposed termination, and no qualified beneficiary provides the trustee with a written objection to the proposed termination on or before the date specified in the notice. Again, upon termination of the trust, the trustee must distribute the trust property in a manner consistent with the purposes of the trust.

Lastly, a trustee may, without court approval, divide a trust into separate trusts, allocating to each separate trust either a fractional share of each asset and each liability held by the original trust or assets having an appropriate aggregate fair market value and fairly representing the appreciation or depreciation in the assets of the original trust as a whole. The beneficiaries of the separate trusts may be different as long as their rights are not impaired.

With Court Approval

Agreement of Beneficiaries. After the death of the settlor (or if the settlor does not join in the NJSA), a noncharitable irrevocable trust may be modified or terminated upon the consent of all the beneficiaries only if a court concludes that the modification is not inconsistent with a material purpose of the trust, or that the continuance of the trust is not necessary to achieve any material purpose of the trust. A sprendthrift provision in a trust instrument is presumed to constitute a material purpose of the trust. If the trust

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Decanting continued

is so terminated, then, upon termination of the trust, the trustee must distribute the trust property as agreed by the beneficiaries.

Unanticipated Circumstances. Alternatively, a court may modify the administrative or dispositive provisions of an irrevocable trust, make an allowance from the principal of the trust, or terminate the trust if, because of circumstances that were not anticipated by the settlor, termination will further the purposes of the trust. Upon termination of the trust, the trustee must distribute the trust property in a manner consistent with the purposes of the trust.

Reformation to Correct Mistakes. Finally, the court may reform a trust instrument, even if unambiguous, to conform to the settlor's intention if it is proved by clear and convincing evidence that the settlor's intent as expressed in the trust instrument was affected by a mistake of fact or law, whether in expression or inducement. The court may provide that the reformation have retroactive effect. Reformation may involve the addition of language not originally in the instrument, or the deletion of language originally included by mistake, if necessary to conform the instrument to the settlor's intent. Because reformation may involve the addition or deletion of language, a person seeking reformation of a trust must prove the settlor's intent by "clear and convincing evidence." Clear and convincing evidence is "the highest standard of proof utilized in civil proceedings, requiring evidence that is so clear, direct, weighty, and convincing as to enable the trier of fact to come to a clear conviction, without hesitancy, of the truth of the precise facts in issue." Thus, reformation of a trust instrument under this provision is not possible without such evidence.

Decanting Pursuant to Terms of Trust

States with decanting statutes generally provide that a trustee's power to decant is treated as the exercise of a special power of appointment for purposes of state law. For example, New York specifically provides that "an exercise of the power to invade trust principal [to appoint part or all of such principal to a trustee of an appointed trust] shall be considered the exercise of a special power of appointment." As defined by New York law, a "special power of appointment" is a power of appointment that is not exercisable in favor of the donee, his estate, his creditors, or the creditors of his estate.

Likewise, Florida law provides that "the exercise of a power to invade principal [to appoint all or part of the principal of the trust in favor of a trustee of one or more other trusts] is considered the exercise of a power of appointment, excluding a power to appoint to the authorized trustee, the authorized trustee's creditors, the authorized trustee's estate, or the creditors of the authorized trustee's estate." Note that these definitions are the same as the definition of a "special power of appointment" under the Internal Revenue Code.

Given that the state statutes allowing decanting treat the decanting power as the exercise of a special power of appointment, in the absence of a Pennsylvania statute specifically authorizing decanting, it is important that Pennsylvania trusts include terms providing the trustee (or other independent third party) with a special power of appointment, exercisable in a manner that will accomplish decanting (i.e., exercisable in favor of another trust). Note that even though Pennsylvania does not specifically authorize decanting by statute, the Act states that "the provisions of a trust instrument prevail over any contrary provisions" of the Act, except as otherwise provided. Thus, if the trust instrument includes a "decanting" or "special power of appointment" provision, the assets of the trust can be decanted to another trust.

Tax Implications of Decanting

While decanting is an important tool that should be included in any trust instrument, it is critical to understand the tax implications of decanting before exercising the power.

Estate Tax. As noted above, the decanting power is treated as a "special power of appointment." Thus, for federal estate tax purposes, if exercised in accordance with the rules governing the exercise of a limited power of appointment, the power should not cause the assets of the trust to be included in the estate of the person exercising the power.

Generation-Skipping Transfer Tax. If the trust from which the assets are decanted is exempt from the generation-skipping transfer (GST) tax, GST tax implications may arise. Unfortunately, many of the issues that are implicated by such a transfer are unresolved and the Internal Revenue Service has not directly addressed them. While there are Treasury Regulations specific to "grandfathered" GST-exempt trusts (trusts that were irrevocable on or before September 25, 1985) that provide safe harbors preserving the GST-exempt status of the assets transferred from such a trust to a new trust, no such regulations directly apply to non-grandfathered GST-exempt trusts. Although those safe harbors on their face only apply to grandfathered trusts, private letter rulings have extended application of the safe harbors to non-grandfathered trusts by analogy on the reasoning that a modification that would not affect the GST-exempt status of a grandfathered trust similarly should

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not affect the GST-exempt status of a non-grandfathered trust. For example, in PLR 200743028, the IRS considered the effect that a trust decanting would have on a non-grandfathered trust and stated "[a]t a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of [a non-grandfathered] trust." Consequently, a decanting from a non-grandfathered GST-exempt trust to a second trust should not affect the trust's GST-exempt status so long as the decanting satisfies the safe harbors provided for with respect to grandfathered trusts.

Income Tax. There also may be income tax implications of decanting assets from one trust to another.

Grantor Trusts. Certain powers held by the grantor, his or her spouse, or a non-adverse party under the terms of a trust will cause the trust to be taxed as a "grantor trust" during the grantor's lifetime. If a trust is taxed as a grantor trust, the income, deductions, and credits of the trust are included in the income and credits of the person treated as the grantor. Thus, if trust assets are decanted from one trust to another trust, with the second trust being taxed as a grantor trust, any income associated with the decanting will be taxed to the grantor, who will be responsible for reporting and paying the tax on such income.

Non-Grantor Trusts. Trusts that are not taxed as "grantor trusts" are taxed as "complex trusts," if the terms of the trust allow for the accumulation of income or distribution of corpus. The allocation of the tax on a complex trust's income as between the trust itself and the beneficiaries who receive distributions from the trust during the tax year is determined based on a concept known as "distributable net income" ("DNI"). With respect to any taxable year, DNI is the taxable income of the trust computed with certain modifications. Although the rules can be quite complicated, basically, a beneficiary who is required to receive income during the year or who actually receives other distributions during the year (including income or principal distributions) will include in his or her income such amounts received, not to exceed the DNI of the trust. Any amounts in excess of DNI will be taxed to the trust. This means that if trust assets are decanted from one trust to another trust, with the second trust being taxed as a complex trust, any income associated with the decanting will be taxed to the second trust to the extent of DNI, and the second trust will be responsible for reporting and paying the tax on such income.

Depending on the amount of income during the year, the first trust may wish to decant the assets to a trust taxed as a grantor trust rather than a non-grantor complex trust (since the tax rate for individuals is generally lower than the tax rate for trusts). However, if the amount of income is substantial, the grantor of the second trust may not wish to be responsible for paying the tax, and thus decanting the assets to a non-grantor complex trust may be more desirable.

Capital Gain. In 2019, the Internal Revenue Service released ten nearly identical private letter rulings addressing the income tax consequences of the early termination of an irrevocable trust. The IRS ruled that, upon termination of a trust, the amounts received by the current income beneficiary and the remainder beneficiaries are amounts received from the sale or exchange among each other of a capital asset. Thus, the IRS ruled the beneficiaries must recognize capital gain upon the termination of the trust. If the IRS is correct, this could be a disastrous outcome, and could likewise apply to decanting assets from one trust to another. However, many practitioners disagree with the IRS's rulings and do not believe the termination of a trust results in capital gain.

Decanting in Light of Recent Tax Proposals

The House Ways and Means Committee previously released its tax proposal (the "Proposal") containing significant changes for "grantor trusts." Under current law, assets transferred to irrevocable grantor trusts through a completed gift are removed from the grantor's estate for federal estate tax purposes. As noted above, the grantor is then responsible for paying the income tax on the trust's income. Such income tax payments by the grantor help to reduce the grantor's estate even further and allow the grantor to make gift tax-free transfers for the benefit of the trust's beneficiaries. In addition, currently sales between a grantor and the grantor trust are ignored for income tax purposes (meaning the grantor does not recognize gain on the sale, and any interest payments due on a note between the trust and grantor are not included in the grantor's income).

However, under the Proposal, sales between a grantor and a grantor trust will no longer be ignored for income tax purposes and will instead result in a realization event (causing the grantor to have to recognize gain on the sale). Further, assets held in a grantor trust created after the date of enactment (or assets contributed post-enactment to a pre-enactment grantor trust) will be included in the grantor's estate for federal estate tax purposes.

If the Proposal is enacted, the benefits of grantor trusts will largely be erased. Grantor trusts created prior to enactment are grandfathered from the changes. However, any post-enactment

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contributions to pre-enactment grantor trusts, or any post-enactment sales between grantors and pre-enactment grantor trusts, will be subject to the new rules under the Proposal. Therefore, trustees of current grantor trusts may wish to consider decanting the assets to a non-grantor trust if post-enactment contributions or sales may occur. These provisions were not included in the House bill, but we don't know what may be included in any final legislation.

Conclusion

In sum, decanting, although not specifically authorized by statute or common law in Pennsylvania, is an important estate planning tool, and terms allowing decanting should be included in any Pennsylvania trust. While Pennsylvania law is not as expansive as other states, the use of modification of trusts under the Act allows Pennsylvania families to achieve similar results. However, before any decanting is performed, the tax implications of the decanting should be considered to ensure that adverse or unintentional tax consequences will not occur.

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Florida Community Property Trust – A Great Idea or Fool's Gold

Alan J. Mittelman, J.D., CLU and Dana Bernstein, Esq.

In July while everyone was preoccupied with the pandemic of 2021 and trying to determine how and if their business models needed to be changed, the Florida legislature passed a new law that is destined to have a big impact on estate planners. It passed the Florida Community Property Trust Act (the "Act"). Now if one practices law in Florida and counsels clients who either are Florida residents or Pennsylvania residents who are thinking of relocating to Florida, one must be familiar with the new Florida law and the choice it presents.

Until this July, property rights in Florida were based upon the common law. Pennsylvania, like all of the original colonies and most of the rest of the country, is a common law state. The alternative is community property law. There only used to be eight states that had community property law in their jurisdictions. In recent years, three additional states, notably Alaska, created elective property ownership regimes that permit residents, and sometimes non-residents, to "elect" property held in that state be treated as community property. Now Florida has joined those ranks by permitting its residents to make an election to treat property held in trust as community property.

What is Community Property?

Community property law essentially governs the rights that spouses have in property acquired during a marriage. In Pennsylvania, a spouse can choose between joint tenants with right of survivorship or tenants by the entirety (functional equivalents in Pennsylvania), tenant in common ownership or separate ownership. In community property states when a married person acquires a new asset, it automatically is deemed to be titled as community property even if the other spouse's name is not listed in the title. Assets owned prior to the marriage and inherited property can remain as separate property. This is similar to Pennsylvania's marital property and separate property regime.

Community property law is quite different from common law. The closest most of us come to community property law is when we read about California divorces. Unless there is a prenuptial or marital agreement, when one divorces in California, all the community property (the property acquirred during the marriage) is divided in half between the spouses. That is quite different from Pennsylvania divorce law. Also, preparing a Will for married California residents is much different because each spouse owns one-half of each asset acquired during the marriage. Therefore, even if a property is titled solely in the name of one's client, the Will only will distribute one-half of the asset. A surviving spouse in a community property state does not have to rely on a state's elective share law when the first spouse dies. Instead, the surviving spouse automatically gets one-half of all the community property. These rules can apply to property located in a community property state even if the owner is not a resident of that state. In fact, the rules also can apply to property owned by a former resident of the community property state. There are good reasons to get local counsel when dealing with clients that own property in a community property state or were ever residents of a

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community property state.

Step-Up In Basis Differences

So now one may be asking why Florida would institute an elective community property regime and what the perceived benefits are for Florida residents. The answer is quite simple! Taxpayers in the U.S. who own community property are treated differently when one of them dies for purposes of the "step-up in basis" rules. If a married couple resides in Pennsylvania, when the first spouse dies, there is a step-up in basis for the separately owned assets of the decedent, but only one-half of the assets owned jointly with the surviving spouse get a step-up.

However, if a surviving spouse owns community property at his or her spouse's death, then there is a full step-up in basis on all the community property, not just the decedent spouse's half. For example, if a married couple owns an asset as tenants by the entirety in Pennsylvania that has an adjusted cost basis of $300,000 and is worth $2 Million when the first spouse dies, then the surviving spouse's new adjusted basis in the asset will be $1,150,000 ($150,000 or half of the adjusted basis of the surviving spouse's half prior to the death plus $1 Million - the fair market value at death of the deceased's half of the property). But if the couple were residents of California and they owned community property worth $2 Million when the first spouse died, then the total adjusted basis in the property would be $2 Million as a result of the community property basis adjustment rules. This always has seemed unfair to me as a Pennsylvania attorney. I have never understood the rationale. Of course, if one practices in a community property state, it is a fabulous loophole in the tax law.

For Pennsylvania residents thinking of relocating to Florida to obtain Florida's many tax benefits, this can be one more reason to do so. Florida does not have a state income tax or a state inheritance tax. Getting a full step-up in basis on formerly jointly owned property could be another advantage to Florida residency.

Before describing the law in greater detail, chasing the step-up in basis tax benefit may be a short-lived planning technique. It seems that there may be major changes in the income, gift and estate tax law. Internal Revenue Code (I.R.C.) §1014 is one section that has been targeted for change for many years. We did have a short-lived experiment with carryover basis in 2010. But this time could be different.

The Florida Community Property Trust

Now that one understands the differences, let's review the new Florida law to see how it works and review the benefits and the disadvantages. First, there is some question about whether the Internal Revenue Service will accept the "full step-up" rule when applied to community property in an "elective" state like Florida. Florida residents still are governed by a common law regime unless they "elect" to treat the assets as community property.

Second, the married couple must create a trust and transfer assets to the trust during their lifetimes. Creating and funding a "Living Trust" (also referred to as a revocable trust) is a common estate planning tool for Florida residents, as Florida tends to be an expensive probate state and Florida law only allows spouses, children and certain other close relatives or Florida residents to be executors. Using a Living Trust may avoid probate and is a way around the executor limitation. In the trust document, the couple must elect to have the property held by the trust treated as community property. This act immediately severs a tenants by the entirety ownership into community property, which is more akin to tenants in common. Each spouse controls his or her half at death. This means that each spouse is free to leave his or her half of the trust to someone other than the surviving spouse. This cannot happen with tenants by the entirety property. With tenants by the entirety, the entire property passes to the surviving spouse. As noted below, the Community Property Trust must be a newly formed trust, not just an amended existing Living Trust.

Third, when the Florida resident converts the ownership of tenants by the entirety property to community property in the trust by Florida residents, the couple loses the creditor protection quality of the tenants by the entirety form of ownership. With tenants by the entirety property, the creditors of one spouse cannot attach a lien to the property, effectively making the creditors wait until both spouses are deceased and then filing the lien if the debtor was the surviving spouse. At that point, the statute of limitations may have expired. Also if the debtor spouse dies first, then the creditor is totally cut off. It is for this reason that so many of our Pennsylvania clients who are professionals and business owners prefer the joint form of ownership with their spouses. Creditor protection!

Lastly, gifting is also more difficult with community property. A gift by one of the community spouses is treated as being made one-half by each spouse. Therefore, I.R.C. §2036 retained beneficial interest rules may create problems if the spouse is a beneficiary of an irrevocable trust to which gifts are being made by the other spouse or if the spouse is a trustee. This could violate one of the most important rules of gifting to irrevocable trusts. The

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settlor cannot also be a trustee of the trust. And if both spouses are treated as making a gift to the trust, then both spouses are deemed to be settlors.

Intersection with Florida Homestead Law

Under the Florida constitution and by statute, the ownership of a home by a married couple requires that the home pass to the surviving spouse. This is an important part of what is known as the homestead law. Florida homestead law also exempts one's personal residence from creditors' claims. There also is a real estate tax reduction for Florida homestead property. These preferences are retained under the Act which means transferring a home to the Community Property Trust does not change the creditor protection and survivor rights afforded by the Homestead laws.

Creating the Florida Community Property Trust

The Act states that the trust be created on or after July 1, 2021, which means that pre-existing revocable trusts will not qualify as Community Property Trusts. Revocable trusts can be decanted into a Florida Community Property Trust, which involves a court filing. Alternatively, the assets in an existing Florida revocable trust can be transferred into a new Community Property Trust. A Community Property Trust also can be an irrevocable trust, although it is likely most will be revocable trusts. The following also is required for a valid Florida Community Property Trust:

1. The trustee must be a "qualified trustee," which is a natural person who is a resident of Florida or a company authorized to act as a trustee in Florida. This means children who are not Florida residents cannot serve as trustees.
2. Both spouses must be Florida residents.
3. One or both of the spouses must transfer property to the trust.
4. There must be a declaration in the trust that it is a Community Property Trust within the meaning of the Act.
5. The trust must be signed by both spouses.
6. The following language must be included in the body of the trust in capital letters:

THE CONSEQUENCES OF THIS COMMUNITY PROPERTY TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND UPON THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD BE SIGNED ONLY AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK COMPETENT AND INDEPENDENT LEGAL ADVICE.

In conclusion, this is a very complex but very important new law. Any client contemplating a move to Florida should be made aware of its existence. And because so many Florida residents use revocable trusts to hold their assets, they should be informed of the new choice available to married residents.

The best advice - BE AWARE, ASK QUESTIONS AND GET RELIABLE ANSWERS.

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Planning for the Future of Artificial Intelligence in Financial Services

Victor Levy and Josh Eskin

There is an old adage about life insurance - that it is always sold, never purchased. What this means is that a client will never pick up the phone and call their financial advisor to tell them, "I need to purchase more life insurance." Instead, there is a process: a financial advisor meets with a prospective client and talks with them about the emotional reality of an early demise, which is often a difficult conversation to have. The advisor provides three important elements to this discussion – 1) a deep understanding of the issue, 2) a sense of care about the client, and 3) solutions to fix the problem.

This experience between people extends to all aspects of estate planning – the planner learns about the problem, approaches it with an understanding beyond the numbers, and comes up with solutions to fix it. Planning around the financial impact of death is traditionally the work of professional advisors who possess qualities such as empathy and trustworthiness, qualities that are critical to work through the planning of these challenging scenarios.

Even though this practice has long been performed by experienced and trusted professionals, new technology is emerging that could upset the relationship-building practice between advisor and client. As computers get faster, they will be able to perform tasks that have traditionally been performed by advisors. In this respect, the emergence

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of artificial intelligence has taken aim at the solutions marketplace in the financial services industry, as technology firms try to create business solutions designed to upend the traditional model for planning. The financial professional community needs to learn about the opportunities and potential threats that artificial intelligence (AI) technologies pose in advance of its widespread adoption so as to ensure the best outcomes for clients.

What is AI?

AI is the common acronym for what technologists call artificial intelligence, which is generally defined as a technology that is capable of some form of reasoning, and subsequently executing a task. This technology is not inherently malicious as depicted in science-fiction films, but instead it can be very helpful in our daily lives. One simple example of how AI might make life easier starts by thinking of a time when you were hungry and you entered "Pizza Near Me" into a Google search. Assuming you have allowed location service on your search application, the search engine sees where you are and then delivers relevant results within seconds. Now take this same example, and let's say the search engine advisor is tracking that every third day you ask Google to search for nearby pizza. After a certain point, an AI algorithm may automatically reach out to you to suggest pizza restaurants on days where it predicts you might order pizza.

With AI, these programs take in data and detect patterns to deliver results more efficiently. To take the simple analogy and apply it to financial planning could be with a client that has spending issues, which create stress on their financial plan. Through the use of AI, it might be possible for an advisor who has been asked to monitor spending to send a reminder or notification on days where the client's financial data has shown higher expenses related to something discretionary like entertainment. Since financial planners cannot be with their clients constantly, AI can provide monitoring or other services that facilitate communication between an advisor and a client. Moreover, if the spending data gets entered into the financial planning cash flow projections in real time, the effect of a large purchase, say a painting for $30,000, may automatically result in a notification to the client that their retirement may have to be delayed for three months due to the purchase.

What are the Possible Benefits of AI in Financial Services?

Time management is one of the most obvious uses for this technology. Even the hardest working financial professionals cannot spend 24 hours per day tending to the needs of their clients. AI could be utilized to service clients around the clock, like how an alarm service monitors one's home. In this sense, a financial plan is created using data that is collected on an ongoing basis, which is then analyzed and communicated to clients.

Human communication is at the heart of the success of AI in financial services. The pandemic has demonstrated the lasting need for human connection when working with clients, especially in times of uncertainty. And, while having an AI advisor or planner might be a convenient method to quickly ensure access to one's finances, its usefulness could easily be outweighed by clients' frustration of having to deal with a computer instead of a person.

Another aspect from which AI derives value is its reliance on data. AI and other machine learning technologies are very good at analyzing large sets of data, which in turn provide advisors and clients with highly useful information. Utilizing these programs can help to alleviate some of the more tedious tasks that planners must perform daily so that more time can be devoted to building human connection – to letting clients know that their planner has their best interest at heart.

Does AI Pose a Threat to the Future of Estate and Financial Planning Jobs?

While it is true that these technologies could potentially outperform advisors and other financial professionals at certain tasks, significant job displacement is not a realistic outcome in the near future. A more probable outcome is that AI becomes a more integral part of the planner's business, but in ways that complement the work that is performed daily. For example, if a client is investing in their accounts in a way that might indicate discomfort with the amount of risk they're taking on, an AI algorithm might be able to recognize these trends and suggest a more appropriately balanced portfolio for their advisor to look over and recommend to their client.

Furthermore, there are already many services out there that provide financial help powered through AI. Firms like Vanguard, Wealthfront and Betterment are seeking to find asset management clients to use algorithm-based programs with an aim to replicate some of the human experience. The same could be said about legal providers like Legal Zoom, who seek to use technology in a similar way, to create a low-cost Do It Yourself ("DIY") approach to legal document drafting. Generally, these are low-cost services that are seen as inferior to the services offered by a live team of experienced professionals. AI, like all new and emerging technology, will be used as a complement to the traditional Advisor/ Client relationship, not as a means for

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displacement.

Looking Ahead

Anticipating advancements in technology has always been a tough thing to do. Thirty years ago, it would have seemed like a crazy idea that we would one day be able to fit into the palm of our hands a means to communicate over video with someone all the way across the planet. It is reasonable to imagine in thirty years that the financial services landscape will be entirely different than it is today. The important thing to keep in mind, however, is that innovation and technological change is gradual. As a result, there will be time to implement new services that can offer value to our clients that technology cannot replicate easily.

Noted futurist and founder of the Strategic Coach, Dan Sullivan, wrote in his 1995 landmark book, The 21st Century Agent, that "the microchip disintegrates all human work except relationship and creativity." Sullivan goes on to say that "[M]icrotechnology, no matter how fast and powerful, will never replace two uniquely human capabilities: the ability to create an infinite number of new things, and the ability to relate to other human beings in an infinite number of new ways." If Sullivan is right, then human professional advisors will not become obsolete so long as they learn to live with and use the advancements in technology to enhance their work and client experience.

In short, there is no rapidly approaching wave of AI coming to replace you. Clients will always need people who understand their values and needs so as to provide them with caring, empathetic, and thoughtful service. In actuality, the possibilities offered by AI should be encouraging rather than something to fear. As this technology continues to improve, so too will the capability and efficiency of you and your team, and in turn, client relationships will strengthen and the capacity to take on more clients should increase.

Victor S. Levy is President of Levy Wealth Management Group, a financial planning and wealth management firm in Center City Philadelphia that just celebrated its 50th anniversary.

Joshua Eskin is a rising senior at the University of Pennsylvania, where he is pursuing a major in Philosophy, Politics and Economics (PPE), and a minor in Data Analytics.

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Life Insurance: 7 Observations from the First ¾ of 2021

Michael C. DeFillipo, CLU, ChFC

A key technique of great writing is that when you don't have anything specific to say, make a list. As we come to the close of 2021, here are seven observations on how the current economic, financial and social landscape are affecting the life insurance marketplace. We'll look at both industry specific trends and several general topics that clients and their advisors have focused on so far this year.

Life Insurance Industry Trends: A Summary of Product, Pricing and Underwriting

1. Product: Continuing a theme that was already starting pre-COVID, many insurance carriers are limiting their balance sheet exposure to products that rely on secondary guarantees. After significant price increases throughout 2020, the number of "true" Guaranteed Universal Life ("GUL") products has diminished; we anticipate those products that are still available will see price increases in the future, particularly in single pay and short pay (10-ish years) situations.

The industry response has been to add flexible secondary guarantees to cash value driven policy types along the universal life chassis (current assumption, indexed and variable). A popular design is to solve for the premium necessary to guarantee the coverage around life expectancy with the policy illustrated on a non-guaranteed basis to last beyond life expectancy. Depending upon the age of the insured and risk class, this type of design can build significant cash value

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and illustrate the policy entering corridor in later years.

There has been a differentiation for Indexed Universal Life ("IUL") and Variable Universal Life ("VUL") designs segmenting the chassis into "protection" and "accumulation" products. By either front-loading or back-loading the cost of insurance, the policies can be more efficiently designed to either grow cash value (focus on growth = accumulation) or provide more cost-effective death benefit (lower premiums = protection).

While not a sub-topic of its own, the use of Long-Term Care and chronic care riders continue to be a popular planning tool to add onto permanent policies. The State of Washington was the first in the nation to pass legislation creating a public long-term care insurance program. Beginning on January 1, 2022, the State of Washington will have a 0.58% payroll tax on all W2 income to fund long-term care coverage for individuals who do not opt out. In order to opt out, individuals must place long-term care coverage (as defined under Section 7702B of the Internal Revenue Code (the "IRC")) in-force by November 1, 2021 and file a waiver. It will be interesting to see if other states follow suit.

2. Pricing: Due to continued downward pressure on fixed income, so-called "general account" products have continued to see decreased interest crediting rates and dividend rates over the first three-quarters of the year. A study completed by Lion Street (Whole Life Dividend Report 2021, For Financial Professional Use Only) showed that of the eight most prominent participating whole life providers, six have reduced their previous dividend rate from -0.20 to -0.50. At the time of this writing there is significant discussion around Federal Reserve rate hikes and maybe-not-so transitory inflation – even if interest rates rise in the general marketplace, it will take several years for the crediting and dividend rates on insurance policies to swing in the positive direction.

The cap rate on many traditional capped 1-year point-to-point accounts is also going through a prolonged period of reduction. The driver of decreasing cap rates is a result of the increased cost of options. At a very, very, very high level, insurance companies use the excess premium beyond the expected yield of the general account to buy an "at the money" call option on a security (such

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as an ETF) that mirrors the benchmark of the indexed account and sell an "out of the money" call option to create a bull call spread. This is a hedge that limits the potential return of the long position while also reducing the net cost of the option. As the price of options increases – due to a combination of short-term interest rates, volatility and dividend yields (on market equities, not Whole Life insurance) – the caps on IUL react in the opposite (down) direction.

A provision of the HEROES Act enacted by Congress in late 2020 that has not garnered a lot of publicity was a change in the previously static interest rate under IRC Section 7702 that determined the maximum funding for life insurance. This rate was set at 4% back in 1988 and did not change based on market conditions. AND SAY IT WITH ME AGAIN: "Due to continued downward pressure on fixed income," these policies – primarily Whole Life contracts – were in danger of lapsing because the premium needed to overcome the suppressed dividend rates couldn't be applied to these policies without violating the rules under the IRC. This change to IRC Section 7702 created a 1% temporary interest rate for the testing that will 'float' in the future. While this was technically a fix for Whole Life insurance, other life insurance products, such as "current assumption" products, will benefit significantly. In short, with a lower threshold for the interest rate assumption to meet the IRC Section 7702 tests, more premium can be applied per unit of death benefit without violating the rules by creating a "Modified Endowment Contract" (a "MEC") (for overfunded policy designs). Consequently, policy owners will be able to get more money into smaller policies, meaning less insurance charges and fee friction, which creates the potential for better cash value accumulation.

3. Underwriting: Life insurance underwriting continues to be influx following the start of the pandemic. Many carriers are lifting COVID-19 restrictions on limited rate classes or age maximums. In addition, several carriers have begun to re-introduce Table Shave programs that provide a beneficial improvement on rate class – typically moving a sub-Standard to Standard for permanent policies – and product-specific rate class improvements from Standard to Preferred.

The underwriting guidelines and temporary programs vary by carrier. Clients who were postponed or declined coverage in the past 18 months may

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want to consider engaging the informal underwriting process with select carriers to determine if coverage at better rates is now available.

General Planning Topics: What's Happening with Comprehensive Financial Planning, Premium Financing, Estate Tax Uncertainty, and Income Tax Planning

4. Comprehensive Financial Planning: The objective of comprehensive planning is an iterative, in-depth fact-finding process that leads to a framework to make future financial decisions. Before the planner puts forth any recommendations, the client and the planner agree on risk tolerance; short, intermediate, and long-term cash flow needs; debt and large future expense management; liquid and illiquid assets, and how they are titled; and a strategy for eventual estate distribution. Going forward, they will evaluate assets on their effectiveness in reaching those goals. Financial product selection (life insurance, income generating annuity, long term care or disability protection) can be inserted or removed from the baseline scenario and analyzed to reflect, under various conditions, the potential changes to the overall outcome.

5. Premium Financing: If you've made it this far, you know what's going on with interest rates. While the low interest rate environment has resulted in challenged product pricing, it does provide individuals the ability to borrow money cheaply. By arbitraging the low cost of money with policy performance (generally linked to IUL policies), policy owners are able to keep out of pocket costs down and redirect the premium 'savings' into higher earning assets.

While the idea of using leverage looks attractive on paper, using leverage to purchase large amounts of life insurance is complicated and adds several additional moving parts. As ambient interest rates tick up in the future, this type of design requires a significant commitment to annual reviews, both of the policy performance and debt/loan management.

In late 2020, the National Association of Insurance Commissioners (the "NAIC") adopted Actuarial Guideline 49A (AG-49A), which changed the way some IUL policies were illustrated. First, products that include return multipliers were limited to reflecting only the illustrated return and not the bonus enhancements; second, the maximum illustration crediting rates was reduced from 100 basis points higher than the policy loan rate to 50 basis points. The net effect of this was a less favorable sales presentation than what was previously available, which, in the case of premium financing, showed a more conservative (tighter) spread between the assumed loan interest rate and policy performance.

6. Estate Tax and Gifting Uncertainty: Though the topic of this piece is to discuss themes from the first nine months of 2021, the threat of changing estate tax legislation seems to be ever-present. Democratic control of Congress and the White House combined with spending in reaction to the pandemic make this current point in time particularly volatile. Various proposals have been put forth containing some adverse change to the amount of the lifetime exemption, treatment of capital gains at death, and limitations to annual gifts that can be made to trusts. At this point in time, it is unclear if any of these changes will be included in final legislation.

Flexibility continues to be a key component of long-term planning. Advisors are using several techniques to act under the current favorable rules while maintaining several options to pivot if the strategies are no longer needed. With respect to insurance, I would like to highlight two primary insurance designs for clients unsure of the need for permanent insurance for tax planning: 1) a Wait-and-See design and 2) implementing convertible term insurance.

In the Wait-and-See approach, a couple would purchase a second-to-die policy designed to have a modest first year premium (in some cases, using capital from existing individual policies that may no longer be needed), which is illustrated to remain in-force for a period of time with no additional premium payments. At some point in the future, perhaps when we have more clarity on future tax laws, they can let the policy lapse with no additional payments; transfer the policy to an Irrevocable Life Insurance Trust and resume funding; or keep the policy as part of their estates and fund it at a higher level to create a tax-preferred accumulation vehicle.

Younger clients, or those of any age without the necessary cash flow to begin funding a second-to-die policy as detailed above, may instead purchase convertible term insurance as a placeholder for a permanent policy. Several highly rated insurance companies will allow term policies on both spouses to be converted into a single survivorship product without the need for additional medical underwriting. Other providers will allow one policy to be converted while requiring the other insured to complete full medical underwriting. Under this scenario, one of the purposes of term insurance is to secure more death benefit than what might be needed for true income protection reasons as a way to lock-in current favorable insurability.

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Implementing non-identical Spousal Lifetime Access Trusts ("SLATs") is a popular estate planning device that allows married couples to utilize the current limits on irrevocable gifts while having the ability to receive distributions during life – it's like having your cake (moving assets and future growth out of your estate) while eating it too (being able to use the money during your lifetime). But there may be an issue that arises when one of the spouses passes away: the surviving spouse will no longer have access to the assets that they gifted in trust for their spouse's benefit. Fortunately, there's a solution to this problem, and, you guessed it … it's life insurance! Some of the SLAT assets can be used to fund a life insurance policy on the other spouse's life to replace the value that is no longer available to the surviving spouse.

In situations where access and control of assets are not a priority – for those clients in the "Bonus Round" where gifting the maximum $11.7MM per person doesn't negatively impact lifestyle – making large gifts under current law should be considered. An approach we've seen increase in popularity is to gift assets to an Irrevocable Life Insurance Trust (ILIT) and fund a permanent insurance policy on an annual basis. The balance of the gift not needed for the premium is then invested in marketable securities with the tax responsibility shifted to the grantor. Stretching out the insurance premiums over the insured's lifetime both improves the Internal Rate of Return on the death benefit through expected mortality and allows the invested assets to continue to grow outside of the taxable estate.

7. Income Tax Planning: With the anticipation of higher income and capital gains taxes, the third tax characteristic of life insurance – tax-free growth and distribution – creates additional planning opportunities. For high-income earners, allocating a portion of their after-tax investible income to a cash accumulation life insurance strategy can create policy cash value that can be withdrawn with ROTH-like tax treatment, without any ERISA-defined contribution limits. Life insurance, when designed properly, can be a cost-efficient long-term saving vehicle compared to a taxable account by trading taxes (and trading costs) for insurance costs.

Many think the VUL chassis provides the most long-term potential for returns and cash value build up, the greatest diversification of investment options, flexibility, control and overall transparency (charges, interest crediting rates) of any insurance product available today. A VUL policy's cash value is updated mark-to-market based on the performance of the underlying funds. Fund options include Indexed (interest credited based on the performance of a widely held Index, but with floors and caps) and Fixed Account (stated interest rate declared by the issuing company) options. Investment options may be changed without charges or tax impact.

Other currently popular planning tools include Private Placement Life Insurance and annuities. One of the biggest drags on investment performance is taxation, particularly with alternative investment / hedge fund strategies and investment portfolios that contain a high amount of turnover, generating short term and/ or long-term capital gains. Through the creation of an Insurance Dedicated Fund (IDF), these niche investment vehicles can eliminate current taxation on gains.

These products are only available to accredited investors, and are not registered investment products. This attribute allows for significantly more flexibility in the design and underlying charges of the insurance chassis: there are no surrender charges imposed by insurers, no limitations on contributions (subject to contract terms and design), and a transparent pricing structure. Since these assets are invested in the Separate Account of the insurer, there is the additional benefit of creditor protection (depending upon the state). This strategy also eliminates K-1s from the underlying investment issuers.

For the fund manager, Private Placement Life Insurance allows these assets to continue under their management. In situations where an investment strategy is tax efficient, Private Placement may provide an extra level of asset retention, as the life insurance or annuity is generally positioned as a long horizon plan.

The SECURE Act, passed in December 2019 and effective as of January 1, 2020 made significant changes to retirement planning. To offset the benefits of delaying Required Minimum Distributions (RMDs) and extending how long IRA contributions can be made, the Act essentially ended the "Stretch" provision of passing an IRA down a generation (certain exemptions apply). Now, Inherited IRAs must be distributed – subject to the beneficiary's normal tax rate – within 10 years of the account owner's death instead of the beneficiary being able to take RMDs "stretched over" the beneficiary's life expectancy. In situations where RMDs or IRA assets are in excess of what is needed to meet lifestyle expenses, using those dollars to fund a tax-free life insurance death benefit is a strategy to mitigate the income tax on the beneficiary, either through a replacement of the assets that would have been inherited in the IRA or as the funding source to pay for the eventual taxes upon distribution of the assets.

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The Takeaways

Change is a constant for the financial professional and their clients. There is always an ongoing balancing act between reacting to the now (and the anticipated soon) and strategizing for the future. Developing strategies that allow for flexibility and positive outcomes independent of transient tax law is where professionals can provide the most value to their clients.

Michael C. DeFillipo, CLU is a Partner of 1847 Private Client Group, in Conshohocken, PA.

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The Accredited Estate Planner Designation Explained

On Tuesday, January 11, 2022, at 12:00 p.m. we will hold an information session "The Accredited Estate Planner® Designation Explained." In the past we have had a terrific response to this event. The presenters will include Susan Austin-Carney of the National Association of Estate Planners & Councils (the "NAEPC") and two of our members Eileen Dougherty and Ann Marie Liotta.

The Accredited Estate Planner® designation (the "AEP designation") is awarded by the NAEPC (of which the Philadelphia Estate Planning Council is a member chapter). It is the only graduate level, multi-disciplinary credential in estate planning, awarded to professionals who meet special requirements of education, experience, knowledge, and professional reputation. Available to actively engaged estate planning professionals, holding the AEP® designation informs clients and colleagues of the designee's dedication to the collaborative approach to estate planning.

If you would like to learn more, please register for the January 11th event on the PEPC website.

Submitted by Kim V. Heyman, Rose Glen, LLC

NAEPC Engagement Committee Member