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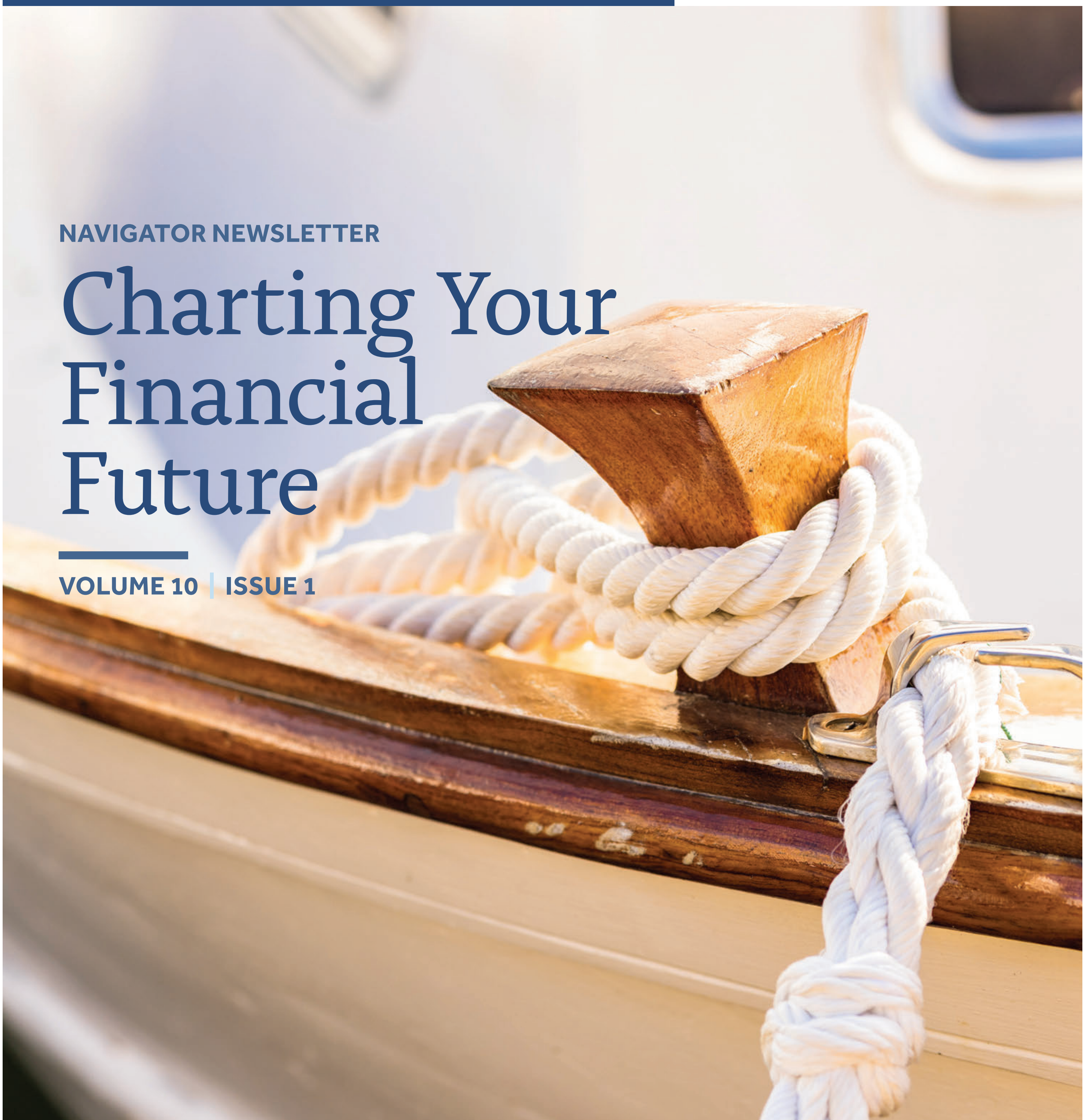

NAVIGATOR NEWSLETTER

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Estate Planning

Creating a flexible estate plan through powers of appointment.

By Eva Stark, JD, LL.M.

When establishing an estate plan, it is impossible to anticipate all future changes in family dynamics, personal finances or applicable tax laws. For these reasons, it is often beneficial to incorporate flexibility in an estate plan so that an existing document may easily be adapted to changing circumstances. One widely used estate planning tool that can add significant flexibility is the power of appointment.

A power of appointment gives a person (i.e., the "powerholder") the ability to direct how the assets subject to the power of appointment will pass. A power of appointment may be made effective during the powerholder's lifetime (i.e., a lifetime power of appointment), or more typically, at the powerholder's death (i.e., a testamentary power of appointment).

Powers of appointment generally fall into two distinct categories: "limited" (also known as "special") and "general" powers of appointment. A limited or special power of appointment permits the powerholder to appoint assets to any person or entity EXCEPT the powerholder, his estate, his creditors, or the creditors of his estate. If the powerholder may appoint assets to a person or entity that falls under these four exceptions, a general power of appointment exists. Both limited and general powers of appointment may be drafted narrowly or broadly to achieve specific estate planning objectives, provided that the four exceptions above are respected.

Whether a power of appointment is considered general or limited is critical as each type has drastically different tax and nontax consequences. Limited powers of appointment typically do not cause estate inclusion and generally do not affect the basis of property subject to the power of appointment (they can, however, have tax consequences under certain circumstances). General powers of appointment, in contrast, will cause assets subject to the power of appointment to be included in the powerholder's taxable estate. Estate inclusion will generally occur even if the power of appointment is never exercised—its mere existence is enough. General powers of appointment also can trigger a basis adjustment to the amount equal to value which is includible in the powerholder's taxable estate.

Non-tax considerations also are important when creating powers of appointment. For example, a general power of appointment over a trust, especially if it is effective during the powerholder's lifetime, could allow the powerholder's creditors to reach trust assets, an often-unintended result. In contrast, a special power of appointment generally will not result in loss of creditor protection.

Due to these major differences, special powers of appointment are often used to allow changes in distribution schemes while general powers of appointment are often used to achieve certain tax objectives.

Common Uses for Powers of Appointment

CHANGING INADVISABLE DISTRIBUTION SCHEMES THROUGH SPECIAL POWERS OF APPOINTMENT

Suppose that Bob died and his estate plan left all of Bob's assets in trust for his wife Mary for her lifetime. Bob's trust provides that at Mary's death, assets are to be divided into equal shares among Bob's three children, and each child's share is to be distributed outright once the child attains age 40. Suppose that all three of the children have attained age 40. The first child is an extraordinarily successful businessperson who does not need her inheritance and any inheritance would only exacerbate her own income tax and estate tax burden. The second child is a stay-at-home parent who is financially savvy and responsible. The third child suffers from a gambling addiction and faces substantial creditor problems.

It could be advisable for the family to channel the trust assets only to the second and third child and to prevent an outright distribution to the third child, but the trust holding Bob's assets became irrevocable at Bob's death.

If the trust grants Mary a limited power of appointment at her death, she could easily utilize that power to appoint assets only to the second and third child and direct that the third child's share be kept in trust for his lifetime for enhanced creditor protection of his inheritance.

TAX PLANNING THROUGH GENERAL POWERS OF APPOINTMENT

Suppose that George died in 2015 and left all his assets in trust for his son, Junior. At his death, George owned land valued at approximately $5 million and no other assets. George's executor allocated his generation-skipping transfer (GST) tax exemption to the trust, and all assets in the trust pass estate and GST tax free (the exemption in 2015 was $5.24 million). In 2020, Junior dies unexpectedly. The land is valued at $9 million at Junior's death. Under the terms of the trust, Junior's trust share passes to his only child, Jane. Jane faces a medical emergency and needs a substantial amount of funds immediately. The Trustee chooses to liquidate the land and distribute funds to Jane's medical providers. Assuming a 20% capital gains rate plus a 3.8% Medicare surtax (and no state income tax), the sale could produce a tax bill of $952,000. However, if Junior would have had a general power of appointment over the trust property, the value of the land ($9 million) would be includible in his taxable estate. Because this value is less than Junior's federal estate tax exemption amount ($11.58 million in 2020), no estate taxes would be triggered (assuming no applicable state-level estate taxes). For income tax purposes, the inclusion of the land into his taxable estate would also trigger a basis step-up in the value of the property to $9 million. As a result, upon liquidation, no capital gains would be produced. All income taxes on the sale would be avoided at no additional estate tax cost.

Simply granting all beneficiaries a general power of appointment at death is generally not advisable, because, as previously noted, the mere existence of the power of appointment will cause estate inclusion for the powerholder. A more precise method is to create a formula general power of appointment that may limit the power of appointment only to an amount equal to: (i) the powerholder's unused estate tax exemption (federal or state), (ii) appreciated property in the trust, and/or (iii) an amount that produces greater income tax savings than the added estate tax cost.

Alternatively, an independent third party might also be given the discretion to grant beneficiaries a general power of appointment at death to the extent that tax savings are produced.

Powers of appointment can add substantial flexibility and result in substantial tax savings if drafted properly. Clients who think they might benefit from such planning should discuss powers of appointment with their estate planning or tax attorney. Creating powers of appointment requires very precise planning and drafting as well as consideration of both tax and non-tax consequences.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.

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Optimizing lifetime gifts for the 99%.

By Jeff Chadwick, JD

As advisors, if we knew when clients were to pass away, who was to survive them, the assets included in their taxable estates, and what the tax laws would be at the time of their deaths, we could all design perfect estate plans. We could also advise clients, with absolute accuracy, when and how to make lifetime gifts to minimize taxes and best effectuate their non-tax objectives. Of course, we cannot know any of these things, so we must simply do the best we can with what we have. In many cases, doing so requires building flexibility into the client's gifting strategy in anticipation of potential changes to the tax laws or a client's family or financial circumstances.

This article, part one of a two-part series, focuses on the 99.8% of Americans without taxable estates. Advisors should work with these clients to identify their non-tax objectives, while also planning to minimize income taxes and reporting obligations.

Part two will address transfer tax planning in light of legislative uncertainty. Although each of these articles discusses a wide array of planning techniques, all techniques are highly fact-specific, and clients should consult with legal and tax counsel prior to making any gifts.

Preliminary Gifting Considerations

At its core, lifetime gifting begins with a client's basic desire to benefit others. Consequently, advisors should first focus on a client's non-tax motivations for gifting, which may include the following:

- To satisfy a beneficiary's current health, educational, or other need;
- Beyond basic needs, to permit a beneficiary to enjoy assets or a certain lifestyle now, particularly while the client is alive and has a chance to enjoy the impact of the gift;
- To equalize prior or current gifts among family members;
- To forgive prior loans;
- To provide a beneficiary with an opportunity to learn how to manage finances;
- To help a beneficiary start a business or invest in an entrepreneurial endeavor;
- To supplement the income of a beneficiary who wishes to enter into a lower-paying, but socially impactful, profession;
- To provide a beneficiary with access to capital without exposing the assets to the claims of the beneficiary's actual or potential creditors;
- To facilitate business succession planning and/or motivate younger family members to participate in a family business; and
- To provide the client with insight regarding how a beneficiary handles gifted assets.

Once a client communicates the desire to make a lifetime gift, the advisor should confirm that the gift is appropriate and help structure the gift to achieve the client's objectives. Below is a non-exhaustive list of preliminary considerations when structuring a client's lifetime gift:

- The client's financial needs, including the client's living expenses and required cash flows;
- The client's desire, if any, to maintain control over the gifted asset;
- The client's desire to protect the transferred assets from the

donee's creditors, divorcing spouses, or even the donee's own spending habits and other vices;

- The client's ability to handle complexity or, in contrast, the client's desire to keep things simple;
- The client's willingness to adhere to best practices to reduce tax and creditor risk;
- The donee's age and station in life, family and financial circumstances, and ability to handle complexity; and
- The assets available to gift, including each asset's fair market value, income tax basis, appreciation potential, and administrative ease.

CLIENT'S FINANCIAL CIRCUMSTANCES

Before advising any client to make a lifetime gift, the client should confirm that, after the gift is made, the client will retain sufficient resources to provide for his or her needs, both now and in the future. This analysis will be unique for each client, and should include the client's financial team.

The client's lifestyle also should be examined, including the client's spending habits, desire for future gifts, potential health care costs, and other factors.

CLIENT'S FAMILY DYNAMICS

While the discussion may be uncomfortable, advisors should press clients to be honest and introspective when considering a substantial gift. For example, would the gift incentivize or disincentivize the donee to be a productive member of society? Is the donee financially responsible, or would this gift contribute to the donee's already poor financial decisionmaking? Does the donee have substance abuse issues or other addictive tendencies? How strong is the donee's marriage? These are tough questions, but good advisors will ask them.

MAKING GIFTS OUTRIGHT OR IN TRUST

There are two basic ways to make a gift—outright or in trust. The biggest advantage to an outright gift is simplicity. With an outright gift, however, the client may lose control of the gifted asset and will forfeit the opportunity to provide the donee with added creditor protection and tax savings. Instead, the client can transfer property to an irrevocable trust for the benefit of the donee, and if the client desires to retain some control, can serve as trustee. A properly structured trust should provide the donee with creditor and divorce protection. Creating and administering an irrevocable trust, however, may increase transaction costs and add complexity, which may not be appropriate for certain clients or certain gifts.

Gifting to Minimize Federal Income Taxes

Historically, many clients made lifetime gifts to minimize federal transfer taxes. With drastic increases to the federal gift and estate tax exemption amount (the "Estate Exemption"), however, the estate tax is no longer relevant to most taxpayers and is significantly less relevant to the remaining few. The table below illustrates the diminishing impact of the estate tax.

Year	Estate Tax Exemption Amount	Estate Tax Rate	Number of Estate Tax Returns	Number of Estate Tax Returns for Taxable Estates	Percentage of Decedents with Taxable Estates
2001	$675,000	55%	109,600	50,500	2.16%
2008	$2,000,000	45%	29,000	15,100	0.69%
2013	$5,250,000	40%	11,300	4,700	0.18%
2018	$11,180,000	40%	4,000	1,800	0.06%

In 2020, the Estate Exemption is $11.58 million per person and the tax rate is 40%. Although the Estate Exemption is scheduled to decrease to $5 million per person in 2026 (indexed for inflation with a base year of 2016), most taxpayers will still not have an estate tax issue, absent a monumental change in the transfer tax system. For most taxpayers it will be more important to plan for reducing income tax than for reducing transfer tax.

To optimize lifetime gifts for income tax purposes, advisors must understand how income tax basis is determined in the wealth transfer context. Section 1015 of the Internal Revenue Code (Code) provides a "carryover" basis for gifted property, meaning that the donee's income tax basis is generally the same as the donor's income tax basis at the time of the gift. By contrast, for most assets included in a client's taxable estate, Code §1014 provides an income tax basis adjustment, either up or down, to fair market value at the client's date of death. Thus, appreciated property receives a "step-up" at death, while depreciated property receives a "step-down." For clients in community property states, Code §1014(b)(6) enhances the potential step-up by providing that both halves of any community property, and not just the one-half interest passing through the deceased spouse's estate, receive an income tax basis adjustment.

For the 99% (and really, the 99.94%) of taxpayers who would not be subject to estate tax under current law, planning should typically focus on preserving the basis step-up for appreciated assets at death, rather than avoiding the estate tax. Income tax basis planning generally falls into one of two categories—"downstream" planning or "upstream" planning.

DOWNSTREAM PLANNING

Downstream planning refers to techniques designed to ensure that a client's assets are included in his or her own taxable estate before being passed on to family members in the next generation. In this regard, advisors should consider the following for clients who do not have taxable estates:

- Avoiding lifetime gifts of highly appreciated assets that would not generate estate tax;
- Preserving capital losses by gifting depreciated assets;
- Swapping high basis assets, such as a cash, for low basis assets from an irrevocable grantor trust that contains a power of substitution;
- Unwinding valuation discounts for client-owned assets;
- Causing inclusion of irrevocable trust assets in the estate of a settlor, a beneficiary, or a third party's estate;
- Converting separate property to community property to facilitate a "double" basis adjustment at each spouse's death; and
- Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and preserve the income tax basis of loss assets, particularly for clients with a shortened life expectancy.

UPSTREAM PLANNING

Upstream planning can potentially benefit a client who owns assets with substantial appreciation and has an older family member, such as a parent, who has "excess" Estate Exemption. The client can create an irrevocable trust for the benefit of a parent and fund the trust with the appreciated assets. The appreciated trust assets should be includable in the parent's estate by granting the parent a testamentary power to appoint the assets among the parent's creditors.

Upon the parent's death, the lapse of the parent's general power of appointment should cause the assets to be included in the parent's taxable estate under Code §2041, entitling the appreciated assets to a basis step-up. The default beneficiary upon the lapse of the parent's general power of appointment is generally a trust for the benefit of the client or the client's family members, which is often designed to be protected from the claims of creditors and divorcing spouses.

While upstream planning is not without risk, it may be a viable option in certain circumstances given today's focus on income tax planning for many clients.

Taking Advantage of the "Freebies"

Many clients prefer to keep their gifts simple by eliminating the need to file annual gift tax returns. For these clients, it is important to understand the "freebies," or gifts that do not consume Estate Exemption.

MARITAL AND CHARITABLE DEDUCTION

A taxpayer's gifts to a U.S. citizen spouse (or certain marital trusts) receive an unlimited marital deduction from federal gift tax and do not consume a taxpayer's Estate Exemption.

Similarly, gifts to a qualified charity (or certain charitable trusts) receive an unlimited charitable deduction.

HEALTH AND EDUCATION EXCLUSION

Certain "qualified transfers" are not treated as transfers for tax purposes. Therefore, they do not consume Estate Exemption, regardless of the donee or amount of the transfer. Code §2503(e)(2) defines qualified transfers as any amount paid on behalf of an individual:

(i) as tuition to an educational organization described in Code §170(b)(1)(A)(ii) for the education or training of such individual; or

(ii) to any person who provides medical care, as defined in Code §213(d), with respect to such individual as payment for such medical care.

In other words, a client may make unlimited direct payments of qualified health and education expenses (the "Health and Education Exclusion") on behalf of any number of persons without utilizing any portion of the taxpayer's Estate Exemption or annual gift exclusion, discussed below.

Transfers intended to qualify for the Health and Education Exclusion, however, must meet several requirements.

- First, the payment must be made directly to the medical service provider or educational institution. Payments made to a 529 plan or directly to an individual, who then utilizes the payment to cover medical or education costs, do not qualify.
- Second, if the payment of a medical expense is reimbursed by insurance, it does not qualify.
- Third, the Health and Education Exclusion only includes payments made to prevent or treat a physical or mental defect or illness, and do not include payments for cosmetic or elective treatments. For education

expenses, qualified transfers only include tuition, and typically exclude payments for room and board, books, and other supplies.

Despite its limitations, the Health and Education Exclusion should not be overlooked when advising clients. For example, a wealthy grandparent could fund all of her family member's educations and provide for all of their medical needs, without utilizing any Estate Exemption or filing any gift tax returns.

ANNUAL GIFT EXCLUSION

In 2020, a donor may make annual gifts of up to $15,000 to as many individuals as the donor chooses without utilizing any portion of the taxpayer's Estate Exemption (the "Annual Gift Exclusion"). If the donor is married and the donor's spouse consents to split the gift, or if the gift is of community property, the donor (and the donor's spouse) may give as much as $30,000, per donee, using the Annual Gift Exclusion.

When used systematically, the Annual Gift Exclusion can be a powerful tool to transfer substantial amounts of wealth over a period of years, especially for a large family with many beneficiaries. Clients who desire to retain control of the gifted assets may consider transfers to trusts, Uniform Transfers to Minors Act accounts, or 529 plans, with the ability to "front-load" contributions to a 529 account by contributing up to five times the annual exclusion amount (currently $75,000 per donor, per donee, or $150,000 per married couple).

Note that a transfer only qualifies for the Annual Gift Exclusion if it is a gift of a "present interest," which requires special planning for transfers to trusts or gifts of closely held business interests.

Note also that a gift may qualify for the Annual Gift Exclusion, but not necessarily for the annual exclusion from federal generation-skipping transfer tax, so gifts to grandchildren's trusts require careful consideration.

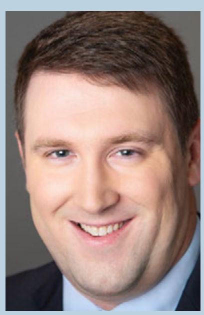
Conclusion

If we knew when clients would pass away, who would survive them, the assets included in their taxable estates, and what the tax laws would be at the time of their deaths, we could advise clients, with absolute accuracy, when and how to make lifetime gifts.

Of course, we cannot know any of these things, so we must do the best we can with what we have. The best approach involves learning as much about the client as possible, starting with the client's non-tax motivations for gifting, as well as the client's ongoing financial needs.

For most clients, it is more appropriate to plan for income tax savings, rather than transfer tax savings, and planners must learn to adapt to this new planning paradigm.

No one approach fits all, and each client's lifetime gifting strategy should be specifically tailored to that client's unique financial and family situation. Flexibility is key, balanced with a heavy dose of practicality. Planners should take comfort that, regardless of the future of the transfer tax system, good advice will always be in demand.



Jeff Chadwick, JD, is a member of the Wealth Preservation Practice Group of Winstead, PC, with offices in Houston and The Woodlands, Texas. Jeff focuses his practice on trust and estate planning for business owners, corporate executives, professional athletes, and other high net worth individuals and families. He strives to provide innovative and practical solutions to a wide range of legal matters, including wealth transfer planning, trust and estate administration, business formation and succession, asset protection, charitable giving, and premarital planning.

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Taxation - Income, Estate, and Gift

Use it or lose it: The gift tax exclusion.

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

The Tax Cuts and Jobs Act of 2017 (TCJA) doubled the lifetime federal estate and gift tax exclusion amounts; however, that law includes an automatic sunset provision and, absent changes in the law before then, the increased benefits provided by that law end at the conclusion of 2025.

Sunset window

Now that 2020 is here, that sunset is just five years away. Certain gifts, such as life insurance, once transferred, are counted and dragged back into an estate if the transfer occurred within three years from the grantor's date of death (called a look-back period).

Once look-back provisions are considered into the planning equation, the window to act to obtain the maximum benefit from the TCJA's increased exclusion amounts further narrows. With potential political environment changes coming later this year with the U.S. national elections determining the control of the Senate, House of Representatives, and the presidency, the possibility exists that these limits could be changed after the outcome of the 2020 election cycle.

If the political winds shift later this year, the mad rush to capitalize on the existing benefits will be intense and may leave many without the planning time to fully use the tax cuts. Therefore, planning to use and benefit from the increased TCJA's gift and estate tax exclusion amounts should be undertaken sooner rather than later.

2020 Exemption

This year, each person may gift or leave $11.58 million to loved ones, and a married couple could potentially gift or leave $23.16 million. The existing law provides that at the conclusion of 2025, the federal exclusion amount reverts back to $5 million indexed for inflation. So, a married couple with assets, including life insurance policies on their lives, could potentially lose out on the ability to transfer in excess of $10 million without federal estate tax if they do not take advantage of the increased limits, which are set to expire. The federal estate tax rate is 40% and, once expired, the tax due on the extra amount would exceed $4 million. When the increased limits expire, they are no longer available for use.

State Estate Tax Opportunity

For people owning property in states with a state-imposed estate tax, the current increased federal gift limits may offer a unique opportunity to avoid a state's estate tax. Most states with an estate tax do not also have a gift tax; however, many states have a look-back period to include gifts made several years prior to death. For individuals subject to state estate taxes, failing to use their available lifetime federal gift tax exclusion amount subjects their estate at death to the full brunt of the state's estate taxation structure.

Trust Planning

Irrevocable trusts are often used to transfer assets out of a person's estate. Once transferred, those assets may grow and not face estate tax again until the assets pay out to a beneficiary who then claims them as part of their estate. For the most part, if a grantor of an irrevocable trust retains an interest in the trust, those assets would still be included in their estate (certain trust provisions exist that may allow a grantor to retain specific rights without triggering this unfortunate result). However, for married couples, one spouse may gift assets to an irrevocable trust for the other spouse as the beneficiary. As long as the trust limits the spouse's access to the assets to an acceptable ascertainable standard, such as for the health, education, maintenance, and support of the spouse, those assets would not be includable in the beneficiary spouse's estate even though the assets would be still be available for that spouse's benefit within the specified limitations provided during their lifetime. Additionally, as long as duplicate reciprocal irrevocable trusts are avoided, each spouse may gift assets to an irrevocable trust for the benefit of the other spouse. This potential strategy serves as a powerful estate planning tool to capitalize on the increased lifetime gift tax exclusion amounts, while permitting a spouse to benefit from the gifted assets.

Business Planning

For entrepreneurs who own their own business or business entities, corporate structuring strategies exist that may permit the company to separate the ownership characteristics of the firm, which would be included in an estate for estate tax purposes, from the control of the firm. By having an irrevocable trust own the bulk of the outstanding non-voting shares or interests, which would constitute most of the company's value, outside of an entrepreneur's estate, the estate tax liability exposure due to the company's valuation would be greatly diminished. Yet, the entrepreneur's ability to control the cash flow stream from the company (such as the ability to determine salaries, bonuses, or distributions) with the retained controlling interest (voting shares) provides for his or her needs but allows for the growth and increased value to accumulate outside of his or her estate.

Multiple strategies exist that may assist individuals and couples to reduce or negate estate and gift taxes aimed at diligent savers, investors, and entrepreneurs. The TCJA's increased exclusion amounts greatly assist in providing some relief; however, discussing, assessing, determining, and implementing these strategies takes some time. Although it may seem like years remain to take advantage of these increased limits, in reality, the opportunity window is closing rather rapidly once look-back provisions, planning, and implementation timeframes are considered.

If reducing the share of your estate given to the government could be a concern, speak with your trusted advisors to discuss using the TCJA's increased exclusion amounts before they expire.

David R. Toups, JD, MBA, CFA®, CFP®, CTFA, joined The Nautilus Group in 2016 after more than 14 years in the private practice of law focused in estate, trust, guardianship, and business planning and litigation. Prior to practicing law, he managed money professionally as an investment portfolio manager for several national corporate fiduciaries. He earned his BBA in marketing from Texas A&M; his MBA, with a finance emphasis, from Sam Houston State; and his JD, with honors, from South Texas College of Law. David is a former U.S. Marine Corps artillery and infantry officer.

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