

# Multigenerational Wealth Management

## Getting a Legacy Up

- The critical first step in planning: Calculating the senior generation's lifetime spending needs
- How to enhance family wealth by allocating assets within a multigenerational framework
- The advantages of quantitative modeling in building an optimal wealth transfer strategy
- The estate planning risks that early mortality poses and how to hedge against them
- Why all wealth transfer plans should be flexible enough to evolve as circumstances change

This research paper is one in a series produced by Bernstein's Wealth Management Group on issues of particular significance to investors of means and their professional advisors.

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# Significant Research Conclusions

Once a family has significant wealth, the problem becomes how to preserve it for future generations—a surprisingly difficult task. Effective multigenerational wealth management requires a family to tackle the personal issues that determine who should benefit from the wealth, the tax hurdles that stand in the way of its efficient transfer, and the capital markets uncertainties that make it challenging to invest it prudently.

**We've developed new research capabilities designed to help families cut through the complexity and identify the solutions most likely to meet the needs of all the generations and charities they'd like to benefit.**

Our enhanced Wealth Forecasting System marries quantitative capital markets modeling with estate planning techniques to help us analyze the many complexities that multigenerational wealth presents. By providing a framework that systematically “stress-tests” potential solutions, the model offers the senior generation and their professional advisors a better understanding of the range of wealth outcomes for each beneficiary, the trade-offs that must be made, and the overall dollar savings that can be realized.

**The first step in multigenerational wealth planning should be to disaggregate family wealth into “core” and “excess” capital. This will drive a family's decisions about both asset allocation and wealth transfer.**

- The senior generation's “core capital”—the minimum amount they need to maintain their lifestyle—should be invested in a balanced mix of traditional, liquid assets.
- Their “excess capital”—any wealth in excess of their core capital—should be earmarked for future generations and charities and allocated in a fashion that matches the risk profile, time horizon, and needs of those beneficiaries.

This bottom-up approach to a family's asset allocation—building the mix generation by generation—can materially enhance overall wealth without putting the senior generation's lifestyle at risk.

After the various portfolios are sized and invested, the senior generation should use one or more transfer strategies to move their excess capital to their desired beneficiaries in a tax-efficient manner, in the right proportions, and at the right speed.

**We've found that many families can achieve most or all of their wealth transfer objectives using only a mix of basic gifts, intentionally defective grantor trusts (IDGTs), and grantor retained annuity trusts (GRATs).**

- By using these strategies in concert, most investors can move *all* of their excess capital out of their estates during their lifetimes while still maintaining ample flexibility to stop or change the course of wealth transfer at any time. *The key is scaling the amount committed to a “rolling” GRAT strategy up or down to meet the family's objectives.*
- In addition to moving wealth to children, basic gifts and IDGTs can pass a surprising amount to grandchildren and more remote descendants transfer-tax-free.
- **Moreover, with enough time, “intergenerational” GRATs—wherein wealth is moved from one generation to the next, and the one following, using rolling GRATs—can be a more efficient way of moving assets to distant descendants than other commonly used strategies.**

*(continued, following page)*

Many families will have specific objectives or challenges that require other wealth transfer strategies. Our Wealth Forecasting System can help determine:

- When adding life insurance to a multigenerational wealth plan may be desirable, and how to determine the right death benefit;
- How installment sales to IDGTs fare in transferring wealth to grandchildren or more remote descendants; and
- How a charitable giving program, through the use of a private foundation, can add financial value for the family and charity, and provide a platform for instilling the virtues of charitable giving in future generations.

**Our quantitative forecasting tool provides a framework for families and their advisors to dimension their decisions, move forward with a sound plan, and adjust it over time as markets and their own circumstances change. ■**

# Multigenerational Wealth Management

## Getting a Legacy Up

*Riches very seldom remain long in the same families.*

Adam Smith

### INTRODUCTION: NAVIGATING THE MULTIGENERATIONAL HEADWINDS

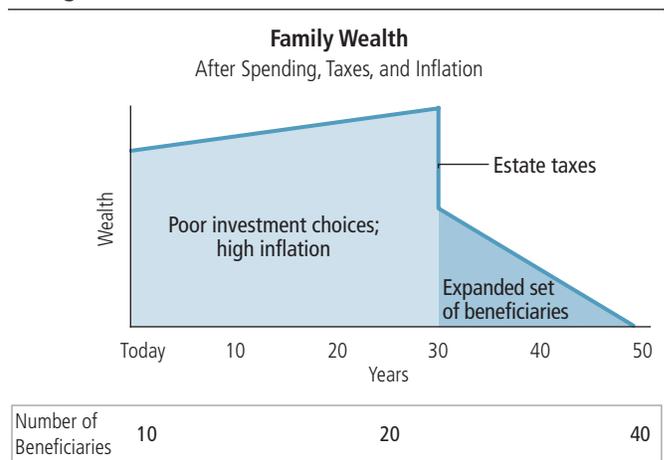
Among the many economic questions explored by Adam Smith, the “father of capitalism,” was whether family wealth could last over successive generations. His conclusion: Despite the best of intentions, family fortunes rarely survive the crossing.

Since then, things have gotten little better. Research shows that about 60% of wealthy families exhaust the greater part of their estate by the second generation; by the third, nine out of 10 family fortunes are gone.<sup>1</sup> The headwinds can be fierce (*Display 1*). A family’s fortune can decline quickly due to lax oversight, spendthrift descendants, or rapidly expanding spending requirements, as a growing pool of beneficiaries comes of age and looks to tap into the wealth. (The number of descendants typically *doubles* with each generation.) Then there’s the prospect of poor investment returns or steady erosion from inflation, which imposes a drag on the assets even as it swells a family’s spending. And finally, there’s the most injurious blow of all: estate taxes, a levy that can halve a family’s wealth in one fell swoop.

#### The Anxiety of Affluence

Equally important as these *economic* concerns are the difficult *emotional* issues families face. These include deeply personal questions, such as who the primary beneficiaries of the wealth should be, how fast the wealth should be moved to those beneficiaries, and whether the wealth will spoil younger generations or create conflict or resentment among family members. Further, the senior generation must determine what safeguards they need to put in place to ensure that the

Display 1  
Multigenerational wealth faces stiff headwinds



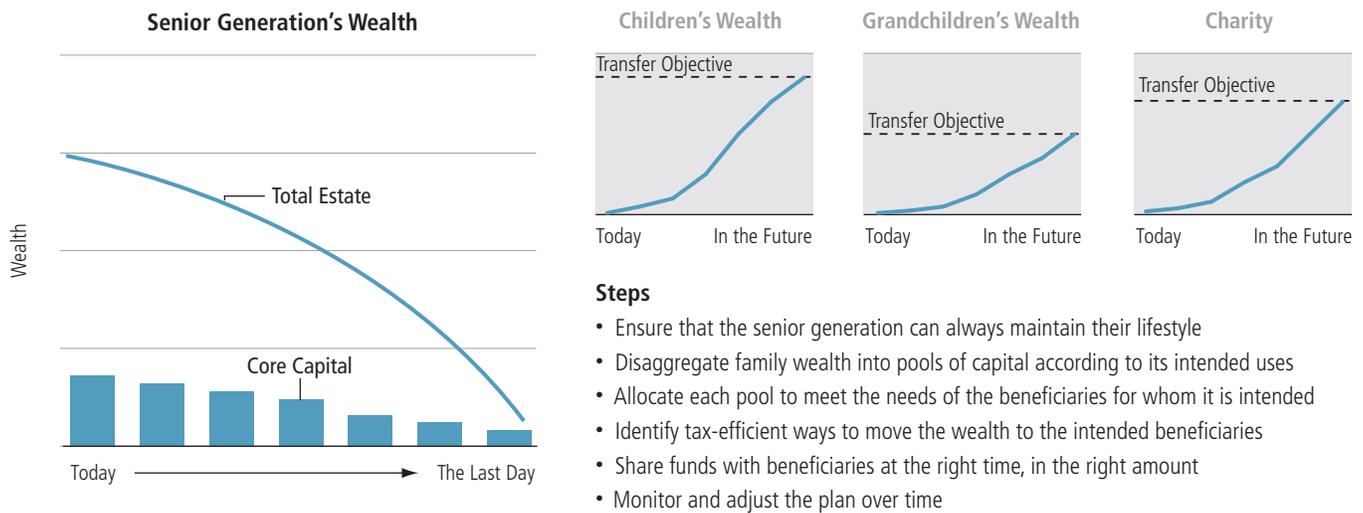
Source: AllianceBernstein

funds are spent responsibly and to retain enough flexibility so they can adjust their wealth transfer plans if their circumstances or desires change. Then there’s the question of their charitable legacy: If that’s an important goal, they must decide on the timing and size of those gifts.

Professionals in the worlds of finance, law, and accounting stand ready with a broad range of strategies designed to help families navigate these choppy waters. But at times it seems as if the sheer array and complexity of alternatives—the myriad trusts, charitable strategies, and insurance vehicles, and the ever-lengthening list of publicly traded asset classes, private funds, collectibles, and other investments—can cause even the most well-intentioned families to freeze in their tracks.

<sup>1</sup> Perry Cochell and Rodney Zeeb, *Beating the Midas Curse* (Heritage Institute Press, 2005)

## Quantitative modeling can help families navigate the way to an optimal solution



Source: AllianceBernstein

### Quantifying and Optimizing the Alternatives

The purpose of our research is to help simplify this process, using quantitative analysis to take some of the financial guesswork out of the planning. We've created a framework that first disaggregates family wealth into appropriate generational “buckets” to allocate and grow the funds in accordance with the risk profiles of the ultimate beneficiaries. The framework then helps to identify an appropriate mix of transfer strategies to move the assets in a tax-efficient manner to younger generations and charity.

Key to our research is a series of enhancements we've made to our proprietary Wealth Forecasting System. These enhancements can help a family and its professional advisors construct a plan that enables the senior generation to be confident that they can both maintain their lifestyle and move their wealth—on their own timetable and in a tax-efficient and targeted manner—to their intended beneficiaries (*Display 2*). The potential benefits, both in terms of dollars and cents and peace of mind, are huge.

Specifically, our planning approach should help families and their professional advisors determine:

- *The amount of funds that the senior generation must retain to meet their lifestyle needs—what we call their “core capital”;*
- *The “excess capital” they have available to give during their lifetimes to descendants or philanthropic causes without jeopardizing their financial security;*
- *The optimal allocation for these two pools of capital, reflecting each pool's unique purpose and the family's priorities;*
- *A method for optimizing among the array of wealth transfer strategies to determine how best to move the wealth to the desired beneficiaries, at the right time and in the right proportions;*
- *The appropriate pace of lifetime wealth transfer, showing the benefits and costs of differing rates of transfer and how to mitigate the risks of early mortality; and*
- *A framework for monitoring and revisiting the plan, as markets, tax laws, and family circumstances change.*

In the research study that follows, we address each of these issues in turn. ■

## ENOUGH ALREADY: QUANTIFYING CORE CAPITAL

*I have enough money to last me the rest of my life, unless I buy something.*

Jackie Mason

### Break It Down to Build It Up: Disaggregating Family Wealth

One of the most formidable obstacles to successful multigenerational planning is the natural tendency of the senior generation to view their wealth as, well, theirs. That is, they think of it, and allocate it, as if it's part of a single portfolio—their own. Families with multigenerational goals, however, can gain tremendous advantages by disaggregating the wealth according to its intended uses—specifically, the individuals and charities it's ultimately meant to benefit. As we'll show, by conceptualizing their wealth in this fashion, the senior generation can better craft a strategy to *build* and *preserve* the family's wealth over time.

The first and most important step in *re-visioning* the family's wealth is to quantify the senior generation's "core capital"—the amount they need to cover their personal spending for as long as they live (*Display 3*). Since investors need to meet their core needs even in dismal markets, we focus on very high

levels of confidence that their money will last. For some, this portfolio *for life* may also include a rainy-day fund—a separate reserve for medical or other life emergencies or for some potential new business venture. Regardless, the core capital figure is the cornerstone for all the planning that follows because it gives the senior generation both financial *security*, since it is quantified using very conservative assumptions, and *flexibility*, since it lets them know the amount of "excess capital" they have available.<sup>2</sup>

Because excess capital has a purpose distinctly different from core capital, these pools of assets should be managed differently. Core capital, for example, should be invested conservatively, to ensure that it will always be sufficient to meet the senior generation's lifestyle needs, even if they encounter extremely hostile markets. Excess capital, on the other hand, should in most cases be invested more aggressively, and can be safely moved out of the senior generation's estates, since the loss of these assets won't jeopardize their lifestyle.

Display 3

### Defining core and excess capital is the first step

Goals for Wealth		Allocation Strategy	Transfer Strategy
Lifestyle Spending	Core Capital	<ul style="list-style-type: none"> <li>Invest for security</li> <li>Balanced mix of liquid, traditional asset classes</li> </ul>	<ul style="list-style-type: none"> <li>Minimum amount that must always remain in the estate</li> </ul>
Emergency Reserve			
Children	Excess Capital	<ul style="list-style-type: none"> <li>Invest more aggressively</li> <li>Tailor allocation to the risk profile of the beneficiaries</li> </ul>	<ul style="list-style-type: none"> <li>Amount that can safely be transferred out of the estate</li> </ul>
Grandchildren			
Great-Grandchildren			
Charity			

Source: AllianceBernstein

<sup>2</sup> In discussing the value of envisioning one's wealth as composed of separate "pools" or "buckets" (e.g., for core and excess capital, or within excess capital, separate pools for each individual beneficiary), we are speaking conceptually, not literally. We do not mean to imply that the funds must always be set aside or moved into a special account or trust. These buckets are simply a way in which an investor can better analyze these sums, so that he or she can develop an optimal asset allocation and wealth transfer plan.

## Covering Your Assets: A Portfolio “For Life”

To determine the size of the core capital, we must determine the rate at which an investor can safely spend without ever needing to cut back.<sup>3</sup> Once we arrive at this “sustainable spending rate,” we can determine the amount the investor needs to maintain his spending.

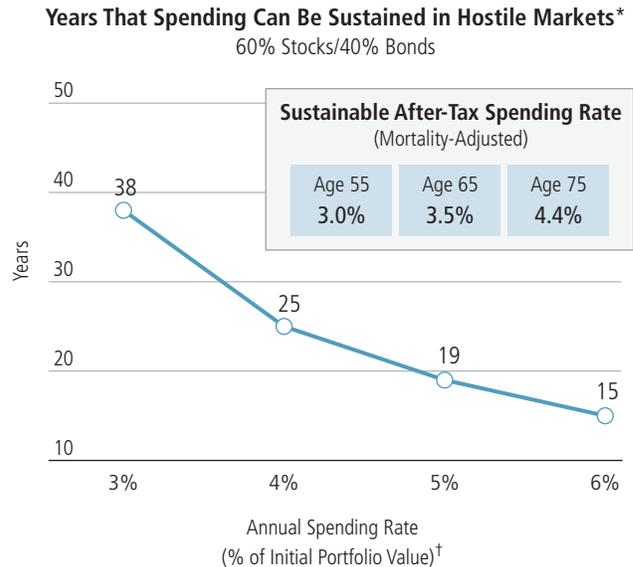
While that process may sound simple, it requires a rigorous forecasting tool that takes into account the vagaries of the capital markets, inflation, taxes, and investor longevity. By simulating 10,000 plausible outcomes—from superior to dismal—for the capital markets and inflation, as well as investor life spans—both long and short—we can stress-test the portfolio to make sure it’s built to last at least as long as the investor himself.<sup>4</sup>

In *Display 4*, we show our estimates of the “life span” of a portfolio invested in a globally diversified 60% stock/40% bond mix, assuming annual spending rates that range from 3% to 6%. In quantifying an investor’s core capital, we want to ensure that he can maintain his spending even in very difficult markets. For that reason, we start by focusing on the number of years an investor can spend with a *very high level of confidence*—here, the 95th percentile of probability from the 10,000 projections we model of capital markets returns and inflation.

The downward sloping line on the display shows that an investor who spends 3% of the initial value of his portfolio (and increases his spending annually with inflation) could sustain that spending for 38 years. By increasing the spending rate to 4%, the investor loses about a third of the portfolio’s longevity, and could sustain his spending for only about 25 years under extremely challenging capital markets conditions and high inflation. Raise the spending rate to 6%, and even more time is taken off the

Display 4

### How long will it last? Gauging a portfolio’s longevity



\* Results at the 95% level of confidence

† Grown with inflation

Unless stated otherwise, throughout this book we assume that stocks are globally diversified (35% US value, 35% US growth, 25% developed foreign markets, 5% emerging markets) and bonds are intermediate-duration municipal and taxable securities (held in taxable and tax-exempt accounts, respectively), and we assume that taxes are levied at the highest marginal federal bracket and state income tax is 6%.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See *Notes on Wealth Forecasting System*, pages 48–49, for further details.

clock, leaving just 15 years of sustainable spending with a high degree of confidence.

If we overlay the probabilities for investor longevity onto our analysis, we can identify the safe spending rate that a couple could sustain for as long as they live (*see Display 4, inset*). For example, we estimate that a 55-year-old couple could safely sustain a 3% spending rate. A couple 10 years older, however, could spend at a higher rate because their time horizon is shorter.<sup>5</sup> We’d peg their sustainable rate at approximately 3.5%. And a couple 75 years old could spend as much as 4.4% of their initial assets.

<sup>3</sup> Unless otherwise indicated, a “spending rate” in this study means a percentage of a portfolio’s initial value, grown with inflation. For example, an investor who has \$10 million and spends at a 5% rate would withdraw \$500,000 the first year, increasing the amount withdrawn annually for inflation. We assume that all spending is net of any applicable taxes (*see Notes on Wealth Forecasting System*, pages 48–49).

<sup>4</sup> Real life is messy, and in actual practice there are typically a host of idiosyncratic elements in any core capital analysis. For example, in many cases our *Wealth Forecasting System* also needs to take into account an investor’s other income, which may vary over time (e.g., pensions that last only for a specific period, or a one-time stock option exercise), as well as certain expenses that change over time (e.g., tuition payments that will end or a one-time home remodeling project).

<sup>5</sup> Although perhaps not as short as some would guess: There’s a 50% chance of at least one member of the couple living beyond age 92.

### Age and spending determine the size of the core capital

Sustainable After-Tax Spending Rate in Hostile Markets*								
Mortality-Adjusted								
Age	50	55	60	65	70	75	80	85
Spending Rate	2.8%	3.0%	3.2%	3.5%	3.9%	4.4%	5.1%	6.0%

Core Capital Amounts								
(60/40 Allocation)								
Annual Spending								
\$200,000	\$ 7.1 Mil.	\$ 6.7 Mil.	\$ 6.3 Mil.	\$ 5.7 Mil.	\$ 5.1 Mil.	\$ 4.5 Mil.	\$ 3.9 Mil.	\$ 3.3 Mil.
\$300,000	10.7	10.0	9.4	8.6	7.7	6.8	5.9	5.0
\$400,000	14.3	13.3	12.5	11.4	10.3	9.1	7.8	6.7
\$500,000	17.9	16.7	15.6	14.3	12.8	11.4	9.8	8.3
\$750,000	26.8	25.0	23.5	21.4	19.2	17.0	14.7	12.5
\$1.0 Mil.	35.7	33.3	31.3	28.6	25.6	22.7	19.6	16.7
\$1.5 Mil.	53.6	50.0	46.9	42.9	38.5	34.1	29.4	25.0

**Example: 60-Year-Old Couple**

Spending Needs: \$500K

÷ Spending Rate: 3.2%

= Core Capital: \$15.6 Mil.

\* Spending is grown with inflation; spending rates assume maintaining spending with a 95% level of confidence.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 48–49, for further details. All information on longevity and mortality-adjusted investment analyses in this study are based on mortality tables compiled in 2000.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

### What’s Your Number?

Display 5 provides a simple method for converting these sustainable spending rates into the amount of core capital that a couple needs. At the top of the display are the maximum after-tax annual spending rates for couples of different ages. On the left are different levels of spending, which we assume will grow with inflation. The point where age and spending level intersect shows the amount we estimate the couple must have to maintain their spending until the survivor’s death, with a 95% degree of confidence.

For example, a 60-year-old couple whose spending needs are \$500,000 a year should set aside \$15.6 million of core capital: They’re relatively young and will need a very large portfolio. But as they age, the amount of core capital they require declines; so when they reach age 70, they’ll need \$12.8 million (a 3.9% spending rate). At age 80, their core capital falls to \$9.8 million.<sup>6</sup>

### How Does Asset Allocation Affect Core Capital?

The guidelines in the above grid are based on a globally diversified 60% stock/40% bond mix. So would investors with different asset allocations have materially different core capital requirements? Perhaps surprisingly, the answer is that regardless of whether an investor’s portfolio is stock-oriented or bond-oriented, his core capital requirement won’t materially differ, as long as the portfolio is well diversified.

To illustrate this, suppose an investor spending at a 4% rate is considering how to allocate his assets. We find that, in poor markets, he can count on about 26 years of spending, provided the assets are invested somewhere in the range of 20% stocks/80% bonds to 60% stocks/40% bonds (Display 6, page 9; see also page 44 of the Appendix for our projected core capital amounts calculated at different asset allocations). On the other hand, if the portfolio is very heavily concentrated in equities, has a large single-stock position, or has a significant commitment to nontraditional

<sup>6</sup> These guidelines are for couples. For a single individual, our core capital estimates would differ (the odds of at least one of the two living longer than a single individual are higher) and would vary based on the gender involved (women have longer life expectancies than men). For a table indicating core capital amounts for individuals, male and female, see the Appendix. Also note that, within each age category, there’s a rather simple, linear relationship among all the amounts: Double the spending and you double the core capital. These numbers, and all those that follow in this study, have been adjusted for inflation.

## A Closer Look: Core Capital for Holders of Illiquid Assets

Determining an investor’s core capital is reasonably simple when his assets are primarily liquid. However, many wealthy investors have mostly illiquid assets—for example, a family business or substantial real estate holdings. Quantifying core capital for an investor with significant illiquid assets requires an approach that differs from our traditional advice.

To begin with, the wealth of this type of investor is concentrated in a particular asset or asset class (e.g., a business or real estate), which increases his risk. Moreover, the investor may be highly averse to selling the asset for a variety of reasons. He may expect it to continue to be more profitable than alternative investments, it may be his life’s work and provide him with important emotional benefits, or it may be a family business that he wants to preserve for his children or employees. And an investor whose wealth is concentrated in an illiquid asset may also be forced to face future “capital calls” to meet debt payments, withstand challenging business or economic cycles, or invest in growth opportunities.

Let’s take the example of a family with significant real estate holdings, the total value of which far exceeds their liquid portfolio. In this case, our approach is to determine the amount of liquid reserves needed to address their goals and the specific risks of their illiquid holdings (*see display above*). The lifestyle reserve is meant to ensure that the senior generation can always maintain their spending, *without selling assets*, even if the cash flows generated by the real estate disappoint in the very long term. The real estate reserve ensures that enough capital is available to protect against a sudden *short-term* downturn in the rental markets or a sudden seizure of the credit markets. And finally, an estate tax reserve helps ensure that the untimely deaths of the senior generation don’t force a sale of the property to fund that tax bill.

### Quantifying core capital for real estate investors

	Liquid Assets	Role	Allocation Driver
Core Capital	Lifestyle Reserve	Supplement spending in case of poor long-term real estate returns	Investor Risk Tolerance
	Real Estate Reserve	Avoid forced sales in poor market and financing environments	Duration of Real Estate Liabilities
	Estate Tax Reserve	Ensure liquidity to meet estate tax liability	Time Horizon
	Excess Capital	Enable legacy goals	Beneficiary Risk Tolerance

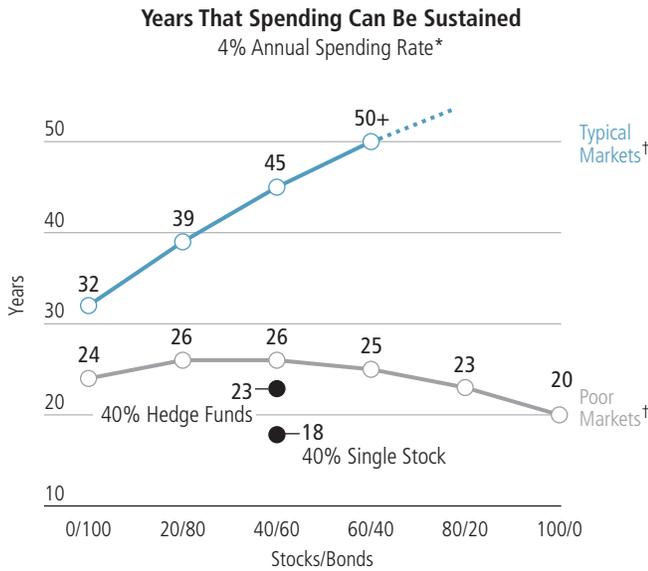
Source: AllianceBernstein

For each reserve, there is a corresponding rationale for its allocation. The lifestyle reserve must have enough growth potential to outpace the senior generation’s spending, which will increase with inflation, yet it must be consistent with their risk profile, including their ability to endure paper losses. The real estate reserve is largely tied to the schedule of debt repayment, so it would be primarily or exclusively in bonds, the duration of which should reflect those liabilities. And the allocation for the estate tax reserve would depend on a number of variables, including time horizon: The prospect of greater longevity argues for a higher proportion of stocks; a shorter horizon suggests more bonds.

Together, these reserves constitute the total core portfolio. Anything that remains, and that won’t be plowed back into the business itself, can be considered excess capital. (For a more extensive discussion of this reserve framework for real estate investors, see our recent publication *Commercial Real Estate: From the Ground Up*.) ■

Display 6

**Increasing equity concentration could augment your excess in typical markets...**



\*Grown with inflation, after taxes

†“Typical markets” represent results at the 50% level of confidence; “poor markets” in this example represent results at the 95% level of confidence.

Hedge funds are assumed to be 50% long/short equity funds with high volatility, and 50% market-neutral funds. Portfolios with hedge funds are 30% globally diversified equities, 30% fixed income, and 40% hedge funds.

Single stock has a beta of 1.0, volatility of 40%, and a dividend yield of 1.5%; the mix of the remainder of the portfolio is assumed to be 40% globally diversified equities and 60% intermediate-term municipal bonds.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the next 50 years. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: AllianceBernstein

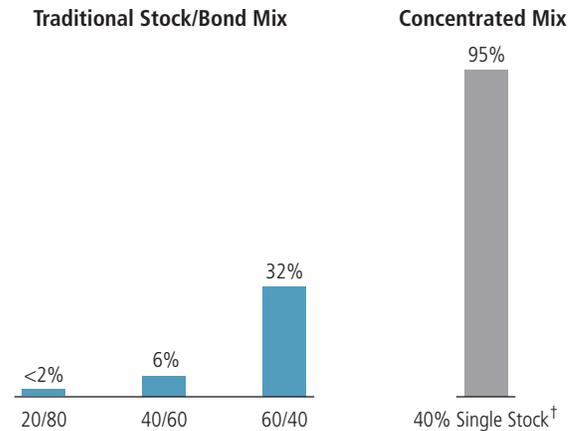
investments (such as hedge funds), the odds grow that the portfolio will fail to generate enough years of spending.<sup>7</sup> Generally speaking, the more concentrated the portfolio, the greater the risk that it will run dry. In other words, *families with concentrated portfolios need a larger amount of core capital.*

For most, the crux of the asset allocation decision for the core portfolio hinges on how an investor balances his desire to increase the portfolio’s growth potential with a greater allocation to equities (increasing the odds that the portfolio will outlive

Display 7

**...but at the cost of higher volatility**

**The Odds of a 20% Peak-to-Trough Decline over 20 Years\***



\*The chance of losing 20% or more over any period in the 20-year time frame, measured from the point of greatest wealth to least.

†Single stock has a beta of 1.0, volatility of 40%, and a dividend yield of 1.5%; the mix of the remainder of the portfolio is assumed to be 40% globally diversified equities and 60% intermediate-term municipal bonds.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: AllianceBernstein

him, with the extra, unused spending years translating into more wealth for his beneficiaries) versus his desire to reduce short-term volatility with a greater allocation to bonds. As *Display 6* shows, a 60/40 stock/bond allocation produces at least 10 more years of spending than a 20/80 mix in typical markets.<sup>8</sup> However, it also produces more volatility: a three-out-of-10 chance of experiencing a 20% or greater decline in wealth at some point over a 20-year period (*Display 7*). And when a large part of the portfolio is made up of a single-stock position, the downside risk is even greater. In short, the allocation decision is highly personal: One investor may feel that he’s already got enough and may want a low-volatility portfolio for the peace of mind it affords, while another may find the likely additional growth appealing. ■

<sup>7</sup> Although it may be appropriate for an investor to have some exposure to hedge funds or private equity in her core portfolio, such exposure should generally be minimized because the returns of such assets are much less certain. For example, the returns of a hedge fund are heavily dependent on manager skill, or “alpha,” which is less reliable than the returns of traditional asset classes, which are tied more closely to broad market movements, or “beta.” For more on these topics, see our analyses of hedge fund returns and single-stock positions in our publications *Hedge Funds: Too Much of a Good Thing?* and *The Envious Dilemma—Concentrated Stock: Hold, Sell, or Hedge?*, respectively.

<sup>8</sup> Our wealth forecasting model presents returns for up to 50 years. A portfolio invested 60% or more in equities will, in typical markets, support more than 50 years of spending at a 4% rate.

## SIZING, SEGMENTING, AND ALLOCATING EXCESS CAPITAL

*The only question with wealth is what do you do with it?*

John D. Rockefeller

The size of the excess capital may be large or small, but its fate is the same—these are funds that are very likely to go unspent and that will wind up with the investor’s descendants, charity, or the government. It’s the investor’s decision—or indecision—that determines their final destination. And although almost all investors agree that giving more money than necessary to the government is undesirable, you don’t have to be as rich as Rockefeller to understand the difficulty of deciding how best to move the funds to beneficiaries. In fact, for some, the most perplexing issue with regard to their wealth is *how to leave it behind*.

### Splitting Heirs: A Spectrum of Transfer Philosophies

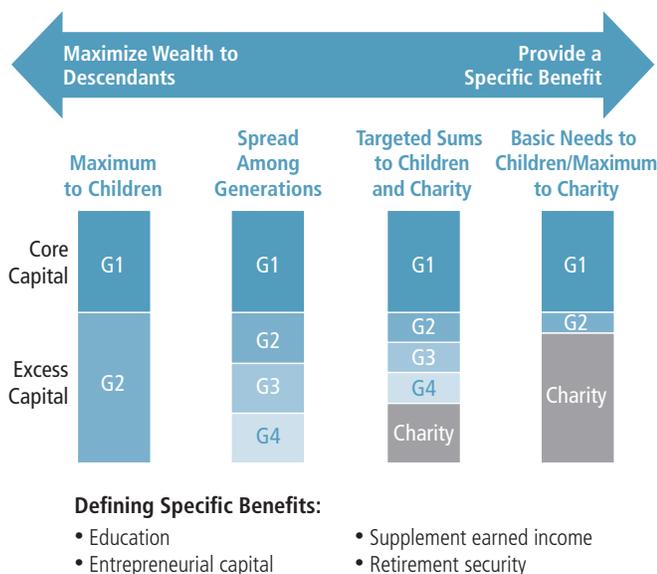
Different investors have different philosophies on how best to share their wealth (*Display 8*). On one end of the spectrum are those who wish to leave as much as possible to their descendants, no matter how large an inheritance that may be. These invest-

tors must determine how to divide their wealth—they may wish to leave it all *directly* to their children and grandchildren, or they may want to distribute all or a portion of the funds in a more controlled manner, such as in a trust that makes distributions once the beneficiaries reach a certain age or that continues in perpetuity to benefit future generations.

At the other end of the spectrum are those who want to provide a *specific* benefit to their descendants, with the remainder set aside to fund, say, a favorite charity or other long-term philanthropic project. For example, they may wish to give their descendants just enough to pay for educational or medical needs, to foster entrepreneurial activities, to supplement income, or to provide retirement security. If so, the senior generation can quantify the amount required to satisfy each goal and the time frame within which the beneficiaries will need the funds. *In this way, funds can be segmented and allocated in a fashion most likely to meet those goals.*

Display 8

### Splitting heirs: A continuum of approaches to wealth transfer



Source: AllianceBernstein

We can use our Wealth Forecasting System to help a family address these issues. For example, say a husband and wife want to provide a fund that could be used in 20 years to supplement their children’s retirement income. One approach is to determine how much the couple must set aside today, and at what allocation, to enable the children to spend at a certain level—say, \$500,000 each per year, grown with inflation over 30 years. According to our projections, based on an allocation of 80% stocks and 20% bonds, that amount is \$16.9 million, assuming that the couple would like to meet that goal with a 90% level of confidence (*Display 9*).<sup>9</sup> If they are unwilling to reserve that much for this purpose, or don’t require such a high level of certainty of meeting that goal, allocating \$9.1 million would leave them with a 50% level of confidence of achieving their objective.

<sup>9</sup> This assumes that the couple can make the funds set aside available to the children undiminished by transfer taxes. Deciding upon the level of confidence with which the couple would like to meet an objective is important because it’s natural for families to prioritize certain objectives over others.

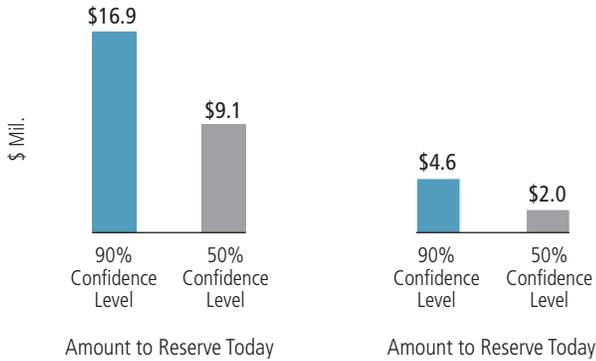
**Defining, timing, and sizing a specific benefit**

**Funds for Children**

**Target:** Provide retirement security for two children (\$500,000 each, annually) beginning in 20 years\*

**Funds for Grandchildren**

**Target:** Provide for college and first home (at age 30) for each of six grandchildren\*



\*After inflation

This assumes the amount reserved for the children is invested 80% in stocks and 20% in bonds, that the amount reserved for the grandchildren is invested 100% in stocks, and that the grandchildren at the start of the analysis are ages 0, 2, 4, 6, 8, and 10. In both cases, we assume the couple can make the amount set aside available to beneficiaries undiminished by transfer taxes.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: AllianceBernstein

The couple can take the same approach for other objectives. For example, they may also want to provide each of six grandchildren with a college education and the funds to buy a first home. Let’s say they’re figuring on \$50,000 a year for four years of college, grown with inflation, when each grandchild reaches 18, and \$500,000 in real dollars for a nest egg at age 30. With these *future* costs and their timing in mind, we can calculate the amount of *current* wealth the family needs to reserve for this purpose, at different levels of confidence and different allocations.

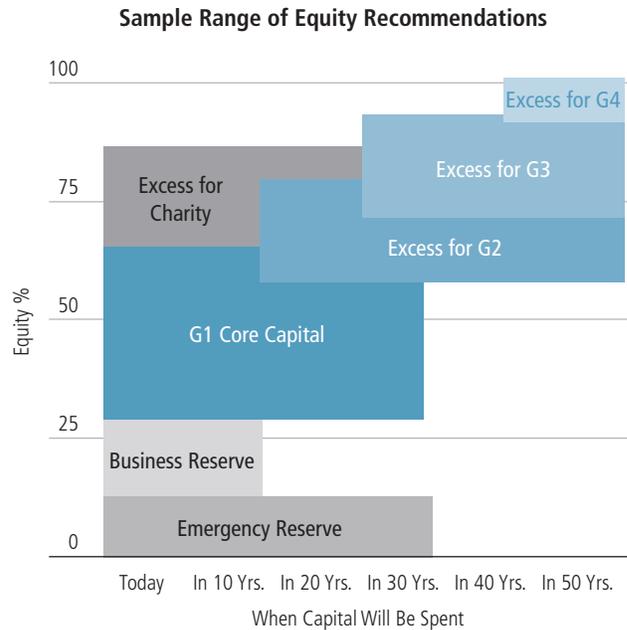
**Finding a Mix That Fits: Multigenerational Allocations**

After the senior generation identify what benefits they want to provide to which beneficiaries, they should incorporate each beneficiary’s risk profile into the plan to improve their overall asset allocation. In allocating the assets, the key factors to

consider include *how vital the funds are* and *when they will be spent*. They should also take into account other sources of capital available to the beneficiaries, such as earned income or outside wealth. They can then set the investment strategy for the bucket “reserved” for each purpose, and build the family’s asset allocation from the bottom up (*Display 10*).

For example, the senior generation’s rainy-day fund, or emergency capital reserve, should be both liquid and safe, because it may be needed at any time—even in the near term. Accordingly, the equity component, if any, should be minimal.<sup>10</sup> Business capital, which might be important to meet the liquidity needs of an illiquid asset in a cyclical downturn or to have available in case a new opportunity arises (which also could happen at any time), should likewise be conservatively allocated to make sure it’s there when needed.

**Bottoms up: Start with core needs, then allocate across the generations**



Source: AllianceBernstein

<sup>10</sup> This is because in the short term, equities can be volatile and suffer significant losses, leaving an investor without adequate funds when he needs them most. Over the longer term, however, the ability of equities to provide significant growth is remarkably consistent. For example, since 1926, there has been no 20-year period in which inflation has outpaced the S&P 500.

## A CLOSER LOOK: Multigenerational Questions—No Easy Answers

The starting point in any transfer plan is for the senior generation to define who they'd like the beneficiaries of the funds to be, how much they'd like to give, and when they'd like them to receive the assets. It seems as if this should be a relatively straightforward exercise. However, wealth transfer is fraught with decisions that are both financially complex and deeply personal—and often the two are at odds. For instance, arguably the most powerful incentive to transfer wealth during one's lifetime is a desire to minimize transfer taxes. But transferring significant funds to younger generations at too young an age runs the risk of spoiling them and curbing the incentive for hard work that contributed to the family's financial success. Balancing tax-efficient wealth transfer with the psychological well-being of the younger generations is a delicate and difficult task. It's a question that has generated many, often contradictory, points of view. Here are a few from the recent—and not-so-recent—past:

*A very rich person should leave his kids enough to do anything but not enough to do nothing.*

Warren Buffett

*To give away money is an easy matter and within any man's power. But to decide to whom to give it and how much and when, for what purpose and how, is neither in every man's power, nor is it an easy matter.*

Aristotle

*If you think of life as like a big pie, you can try to hold the whole pie and kill yourself trying to keep it, or you can slice it up and give some to the people around you, and you still have plenty left for yourself.*

Jay Leno

*Money is like manure; it's not worth a thing unless it's spread around encouraging young things to grow.*

Thornton Wilder,  
*The Matchmaker*

*As I started getting rich, I started thinking, "What the hell am I going to do with all this money?"*

Ted Turner

*Of course, money...will steadily work to unspiritualize and unchurch the people to whom it was bequeathed.*

Ralph Waldo Emerson

*A philanthropist is a generous man whose relatives hate him.*

Anonymous

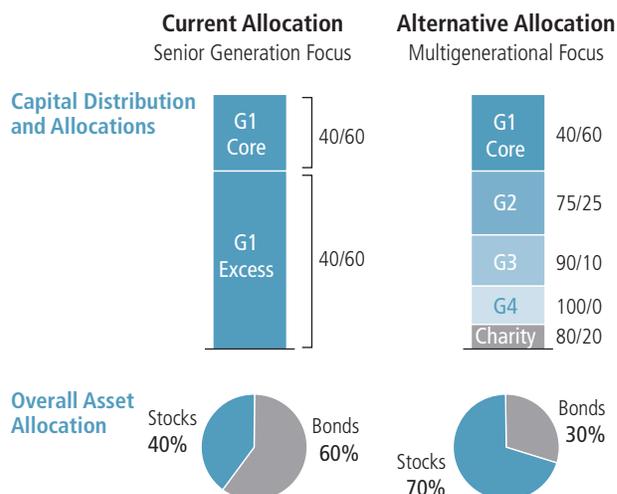
As discussed above, core capital is the amount required to support the senior generation’s spending with a very high degree of confidence. It will be tapped continuously over their remaining life spans and should be allocated in line with their tolerance for volatility; somewhere between 40% and 60% in equities is typical. Assuming the children are currently employed and might not need to draw from their share of their parents’ excess capital until well into the future, equities should play a much greater role in the allocation of those funds. And this emphasis on equities is even more desirable for buckets earmarked for grandchildren or more remote descendants; here the time horizon is even longer, and capital allocated to those beneficiaries should have the highest risk profile. In general, the more risk that can be taken, the higher the proportion of equities one should have in the allocation.<sup>11</sup>

To understand the benefits of such a multigenerational approach to asset allocation, consider a family with \$50 million in liquid assets whose senior generation spend \$500,000 per year. Say the parents decide that, after reserving their core capital and setting aside an additional \$3 million emergency reserve, they want to allocate their remaining assets to maximize the wealth that will eventually pass to their descendants. Currently, all their liquid assets are invested conservatively—40% in globally diversified stocks and 60% in bonds—reflecting the senior generation’s belief that, given their level of wealth, it isn’t prudent to take any more risk.

By exploring the family’s goals, we can size the various generational buckets and determine a “multigenerational” asset allocation optimized to achieve those goals. For example, the senior generation aren’t interested in making any money available to their children for at least another 10 years, so a more aggressive posture for those funds makes sense. The time horizon for the grandchildren and great-grandchildren is even

Display 11

### Building the asset allocation generation by generation



Source: AllianceBernstein

longer, so a nearly all-equity strategy may be appropriate for this bucket. Building the allocation generation by generation results in an overall family asset allocation of 70% global stocks/30% bonds instead of the original 40/60 mix (*Display 11*).

This analysis yields two key insights:

**1. The senior generation’s lifestyle won’t be at risk:**

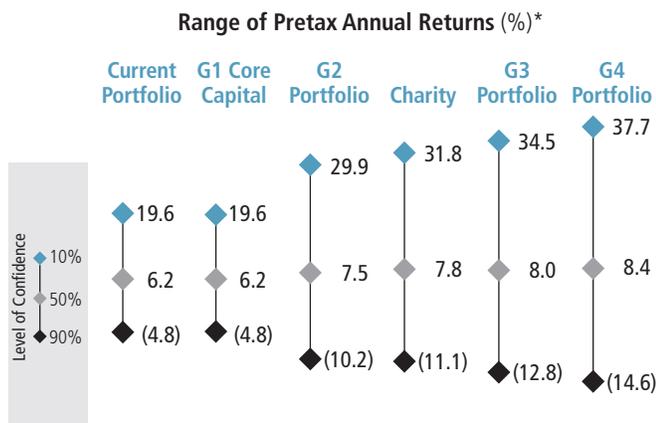
Since our asset allocation methodology starts by protecting the senior generation’s core capital needs, they can be confident that they’ll never run out of money. By definition, their excess capital is money they’re highly unlikely to spend—in effect, they’re just holding and managing it for their descendants. As a result, they feel psychologically comfortable with the increased volatility that comes with a higher equity allocation for that excess capital. As *Display 12, following page*, illustrates, all the incremental volatility is being absorbed by the younger-generation family members, who are the beneficiaries of the excess funds and who have the time horizon and risk tolerance to handle it.<sup>12</sup>

<sup>11</sup> We use equities as a proxy for “risky assets” in this illustration. In practice, investors with ample excess capital and long time horizons might well choose to include other assets as well, such as private equity, real estate, and hedge funds, for a portion of the allocation.

<sup>12</sup> Still, it’s important to note that, taken as a whole, the portfolio will be more volatile, and the senior generation must understand that.

Display 12

**The funds earmarked for the beneficiaries absorb all the incremental risk...**



\* Over 50 years

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: AllianceBernstein

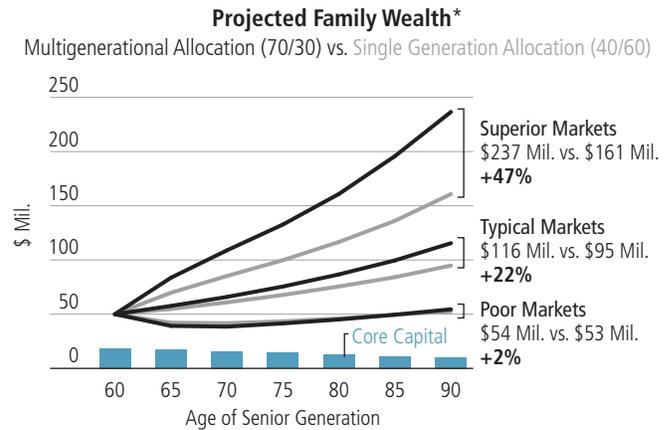
**2. The family’s total wealth is likely to increase substantially:**

By the time the senior generation reach their life expectancies, the family’s wealth is over 20% greater, in typical markets, with no downside risk in poor markets (*Display 13*). And the upside, in strong capital markets environments, is enormous. Moreover, regardless of the portfolio’s returns, the wealth will continue to exceed the senior generation’s core capital.

However, there is one liability of this significant increase in total family wealth: the specter of an

Display 13

**...and family wealth increases substantially**



\* After spending, taxes, and inflation

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. “Superior markets” represent results at the 10% level of confidence in our Wealth Forecasting model; “typical markets,” the 50% level of confidence; and “poor markets,” the 90% level of confidence. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

even larger estate tax bill. In fact, based on a current top federal estate tax rate of 45%, the family in the above example would see close to half of the \$116 million they are likely to build lost to federal estate taxes.<sup>13</sup> So once the family puts in place a multigenerational asset allocation to *build* family wealth, the next step is to *reduce* the amount of it remaining in the senior generation’s estates at their deaths by engaging in tax-efficient wealth transfer strategies during their lifetimes. ■

<sup>13</sup> Many states also impose a state death tax, which can add to the overall tax burden.

## OPTIMIZING WEALTH TRANSFER: AT THE RIGHT PACE, AT THE RIGHT TIME

*Observe due measure, for right timing is in all things the most important factor.*

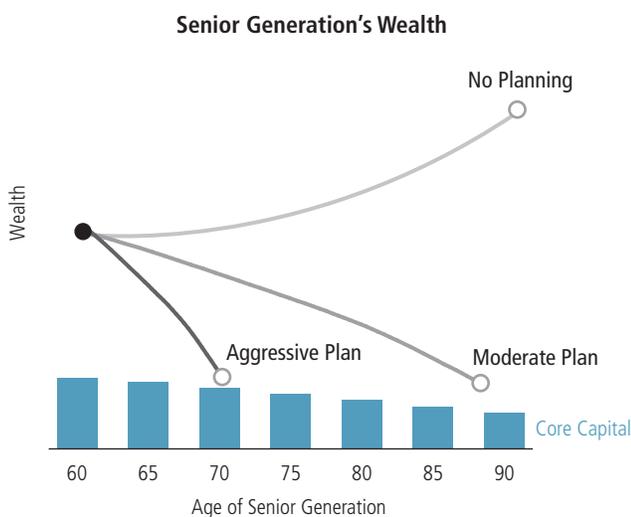
Hesiod

### It's About Time

Faced with the prospect of a significant amount of excess capital and a large estate tax, the essential question for most families is not *whether* to transfer assets to their descendants or charities, but *when*. This requires the senior generation to engage in a difficult balancing act: On the one hand, moving excess capital to beneficiaries as quickly as possible maximizes the likelihood of reducing estate taxes. And if the goal is to move more money to charity, the sooner the gift is made, the quicker the charitable impact and the greater the amount of tax-free growth on the gift.<sup>14</sup> On the other hand, a more gradual transfer might satisfy the senior generation's desire to retain control and flexibility. Regardless of the pace the family decides on, the senior generation should identify the right strategies to achieve their intended wealth transfer trajectory without putting their core capital at risk (*Display 14*).

Display 14

**Planning the pace of wealth transfer, while ensuring that core needs are met**



Source: AllianceBernstein

### A Taxing Environment

Of course, constructing and executing a sound wealth transfer plan is easier said than done. This is largely because donors can't easily give as much to their descendants as they want, whenever they want. The reason is simple—the government imposes three “transfer taxes” on the transmission of wealth:

- **Estate tax:** Currently levied at a top rate of 45%, the federal estate tax applies upon death to the transfer of assets to someone other than a spouse or charity. Generally speaking, it takes a bite out of estates having assets in excess of the current \$2 million estate tax applicable exclusion amount (the estate tax exclusion).<sup>15</sup>
- **Gift tax:** The lifetime gift tax applicable exclusion amount (the gift tax exclusion) from federal gift tax is limited to \$1 million per donor. In general, gifts in excess of this exclusion to someone other than a spouse or a charity are subject to tax at rates up to 45%.<sup>16</sup>
- **Generation-skipping transfer (GST) tax:** In general, this is a 45% tax on transfers to or for the benefit of grandchildren or more remote descendants. A donor can exempt up to \$2 million from this tax, a valuable benefit for families with multigenerational intent.

Together, these three levies make it challenging for the senior generation to transfer substantial wealth without significant erosion.

### A Surfeit of Strategies:

#### The Alphabet Soup of Wealth Transfer Techniques

Thankfully, there's no shortage of techniques to aid families in their efforts to minimize these taxes (*Display 15, page 17; see the Appendix for more detailed descriptions*). But sorting through the alphabet soup of planning acronyms and weighing the pros and cons of each strategy can be overwhelming. Furthermore,

<sup>14</sup> Furthermore, donors get an income tax deduction for lifetime charitable gifts. See pages 35–39 for more details.

<sup>15</sup> Under the estate plans put in place by most married couples, the estate tax is deferred until the death of the surviving spouse.

<sup>16</sup> Special tax rules apply with respect to spouses who are not US citizens.

## A CLOSER LOOK: Managing Multigenerational Wealth—From Art to Science

*It is far better to foresee even without certainty than not to foresee at all.*

Henri Poincaré

Often, the financial modeling of wealth transfer strategies tends to be overly simplistic. For example, it may assume that the assets subject to transfer will produce a constant rate of return based on a historical average. Focusing on averages isn't a bad way to start, but often they don't tell us enough about future returns. After all, the average outcome almost never occurs: Most of the time we experience something better or worse—sometimes much better or much worse.

For example, assume that a client transfers \$10 million of publicly traded stocks to a 10-year, zeroed-out GRAT. (For an explanation of how GRATs work, see pages 20–21.) The display below shows three possible paths of returns that the assets could take over this 10-year period. In each case, the stocks produce a compound annual return of 8%. However, the extent to which the GRAT succeeds (or fails) differs greatly depending on which path of returns the stocks take along the way. As the remainder amounts in the display show (ranging from \$5.7

### The modeling challenge: The path of returns matters

	Average Return	Return Path 1	Return Path 2
Year 1	8.0%	25.9%	(3.5)%
Year 2	8.0	14.1	(1.1)
Year 3	8.0	11.6	2.6
Year 4	8.0	14.7	2.4
Year 5	8.0	9.8	6.9
Year 6	8.0	6.9	9.8
Year 7	8.0	2.4	14.7
Year 8	8.0	2.6	11.6
Year 9	8.0	(1.1)	14.1
Year 10	8.0	(3.5)	25.9
<b>Compound Annual Return</b>	<b>8.0</b>	<b>8.0</b>	<b>8.0</b>
<b>Remainder (\$ Mil.)</b>	<b>\$1.9</b>	<b>\$5.7</b>	<b>\$0.0 (Failure)</b>

10-Year, Zeroed-Out GRAT Contribution: \$10 Million  
Section 7520 Rate: 6.0% Annuity: \$1,358,677

Source: AllianceBernstein

million to zero), reliance on an assumed constant rate of return does not tell us with any precision what we can expect to achieve by implementing a particular wealth transfer technique, or how that technique compares to potential alternative techniques.

To address this research need, we use our Wealth Forecasting System to evaluate estate planning strategies and their asset allocations to quantify the likelihood of achieving a particular transfer objective. Our analyses rely upon a proprietary Monte Carlo model that simulates 10,000 plausible future paths of returns for each asset class and inflation and produces a probability distribution of outcomes. However, the model does not randomly draw from a set of historical returns to produce estimates for the future. Instead, our forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of an analysis; and (4) factor in a reasonable degree of randomness and unpredictability. In addition, our model produces 10,000 plausible paths for the Section 7520 rate, and for mortality-adjusted analyses, we incorporate life expectancy. As an example, there's a 50% chance that at least one member of a 65-year-old couple will survive until age 92. Consequently, in a mortality-adjusted analysis for that couple, at least one will survive until age 92 in half of the 10,000 scenarios we model; in the other half, both die at some earlier time.

As a result, the most important planning questions that a wealthy family faces—How much can we tax-efficiently transfer to future generations? How quickly can we do it? and How likely are we to achieve our goals?—can be answered with greater precision. ■

**Evaluating the alphabet soup of transfer techniques...**



Source: AllianceBernstein

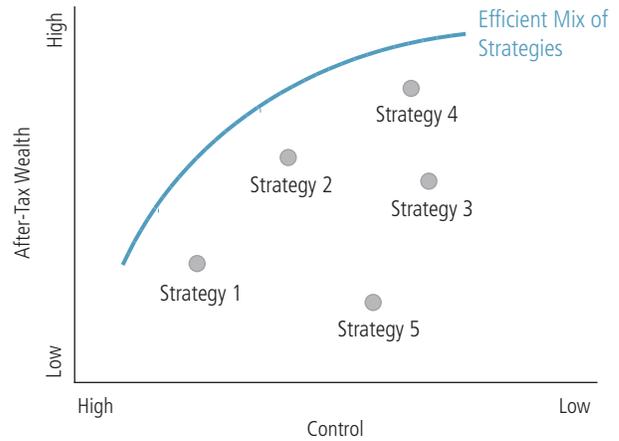
it's not simply about finding the right *one*, but the right *combination*, as no single strategy is likely to meet all of a wealthy family's objectives.

**Optimizing Multigenerational Wealth Transfer**

However, we can help manage the complexity. By using quantitative modeling to analyze various estate planning strategies, we can better understand a strategy's key variables, including the *pace* at which it is likely to move funds to younger generations, its *scalability* (how much wealth it can move), its *flexibility* (its ability to move funds to multiple generations, or to be adjusted over time), and its overall *efficiency* (how likely it is to be successful in meeting a particular transfer objective). The result, we believe, is a real advance in the art of wealth transfer planning: a framework for identifying the best mix of strategies—something akin to a wealth-planning efficient frontier—tailored to meet the specific goals of each family (Display 16). (See also “A Closer Look: Managing Multigenerational Wealth—From Art to Science.”)

Several observations have emerged from our research. Perhaps the most significant is that a donor with a large, liquid estate often can satisfy all of his wealth transfer goals using just a few straightforward

**...to optimize the estate plan**



Source: AllianceBernstein

strategies: direct gifts, IDGTs, and GRATs. With these techniques, a donor can move very substantial amounts of wealth to future generations at little, if any, tax cost. Moreover, the amounts committed to these strategies can be adjusted to satisfy a range of objectives relating to the size and speed of the transfer and the intended recipients.

Some families, however, must use additional strategies. And they can easily do so. For example, a donor worried about early mortality can supplement these strategies through the purchase of *life insurance*. A family with substantial illiquid assets can use *longer-term GRATs* or other solutions more tailored to their specific needs. Families who want to ramp up the amount available to distant generations might employ such techniques as an *installment sale to an IDGT* or “*intergenerational*” GRATs (see pages 32–35 for more details). And a donor with multigenerational philanthropic objectives can add a charitable vehicle, such as a *private foundation*, to solidify that piece of the family legacy.

In the next three sections, we illustrate the relative merits of each of these strategies and how they can best be combined, weighted, and prioritized. ■

## GIFTS, GRATs, AND IDGTs: THE BEDROCK OF MULTIGENERATIONAL WEALTH TRANSFER

*Regardless of the size of the excess capital or the specifics of the family's goals, a combination of one or more of three basic estate planning tools—gifts, GRATs, and IDGTs—can serve as the bedrock of a multigenerational wealth transfer strategy.*

### Back to Basics

It's easy to see why a very wealthy family might view simple tax-free giving strategies—like “annual exclusion” gifts of \$12,000 per donee<sup>17</sup> and the lifetime gift tax exclusion of \$1 million per donor<sup>18</sup>—as somewhat of an afterthought. Such gifts just don't *seem* as if they're large enough to move the needle. But these basic strategies not only can move a surprising amount of wealth, they can also lay important groundwork for more substantial wealth transfer later on.

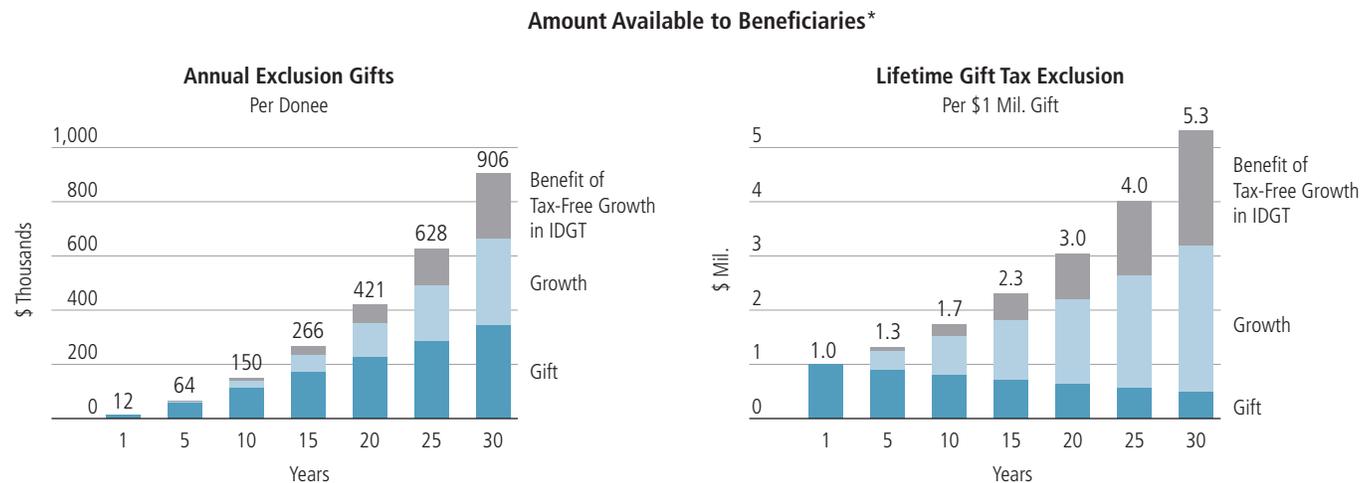
Furthermore, starting these gifts early maximizes their long-term benefit. Gifts allow a donor to move all future income and appreciation on the

transferred property out of his estate. So for assets that grow in value, the earlier the funds are moved, the greater the transfer tax savings will be. Also, in the case of annual exclusion gifts, a gift not made is a wasted opportunity, since each gift constitutes a “use it or lose it” proposition.

Plus, assuming a donee doesn't need the funds for immediate consumption, the donor can make these gifts to IDGTs, which further enhances their benefit. The advantage is that the funds in the trust are excluded from the donor's estate for estate tax purposes, but the income generated by the funds is included in the donor's income for income tax purposes.<sup>19</sup> Because the donor is legally responsible for

Display 17

### The gifts that keep on giving: Gifts and IDGTs are a powerful combination



\*Median results, after inflation

All accounts are invested in 100% globally diversified equities.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: AllianceBernstein

<sup>17</sup> The annual exclusion refers to a provision of the tax law under which the first \$12,000 of property transferred in a given year to a donee or to certain types of trusts for his or her benefit is excluded in the computation of the donor's taxable gifts in that year. One such trust is a trust that gives a beneficiary what's called a “Crummey” power, which is a lapsing right of withdrawal over contributions to the trust. The annual exclusion is indexed for inflation and is therefore expected to increase over time. See IRC § 2503(b)(2). An annual exclusion gift made directly to a grandchild or to certain types of trusts for his or her benefit is also free from GST tax and doesn't use up any of the donor's GST exemption.

<sup>18</sup> The use of the gift tax exclusion offsets on a dollar-for-dollar basis the amount of the estate tax exclusion available at the donor's death.

<sup>19</sup> There are a number of interests in or powers over a trust that a grantor may have that will cause it to be an IDGT. One common provision used by planners is for an IDGT to give the grantor the power, acting in a nonfiduciary capacity, to reacquire the trust principal by substituting other property of equivalent value. See IRC § 675(4). Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

paying the income tax on the trust income, he can further reduce his estate while letting the trust assets grow *tax-free* for the younger generations.<sup>20</sup>

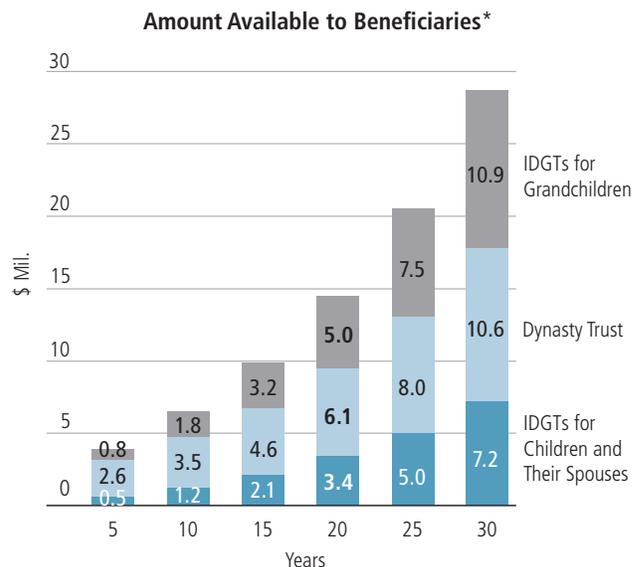
We can use our Wealth Forecasting System to quantify how much money a donor can move, and how quickly he can move it, just by making basic gifts to IDGTs. For example, by making annual exclusion gifts to a trust for one beneficiary, a donor can transfer more than \$400,000 in inflation-adjusted dollars over 20 years' time in typical markets (*Display 17*). Over 30 years that figure more than doubles, to over \$900,000, as the transferred assets grow. Importantly, of that \$900,000, about \$240,000 is attributable to the senior generation's payment of the income taxes on the trust's income.

Moreover, by using his \$1 million gift tax exclusion to make a gift to a separate IDGT, a donor can transfer \$3 million in 20 years, and over \$5 million in three decades. Note that over 30 years, about 65% more wealth is moved by making the gift to an IDGT than by making it to a non-grantor trust. And should the donor allocate \$1 million of his GST exemption to that IDGT, the funds could also benefit his grandchildren and more remote descendants without ever being subject to transfer tax.<sup>21</sup>

The wealth transfer potential quickly increases for a married couple with multiple donees. As an example, consider a 60-year-old couple with 10 donees: two children, the children's two spouses, and six grandchildren. By making annual exclusion gifts to IDGTs for the two children and their spouses, annual exclusion gifts to separate IDGTs for the six grandchildren, and a \$2 million gift to another, separate GST-exempt IDGT (the "dynasty trust"), the senior generation can transfer a total of almost \$30 million in inflation-adjusted wealth in 30 years' time in typical markets (*Display 18*). (See the Appendix, page 45, for our wealth projections per donee, at varying levels of confidence, for assets held in an IDGT or taxable trust.)

Display 18

### The wealth transfer potential of making tax-free gifts to IDGTs



\*Median results; after inflation

All accounts are invested in 100% globally diversified equities.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: AllianceBernstein

### Targeted Giving with Gifts

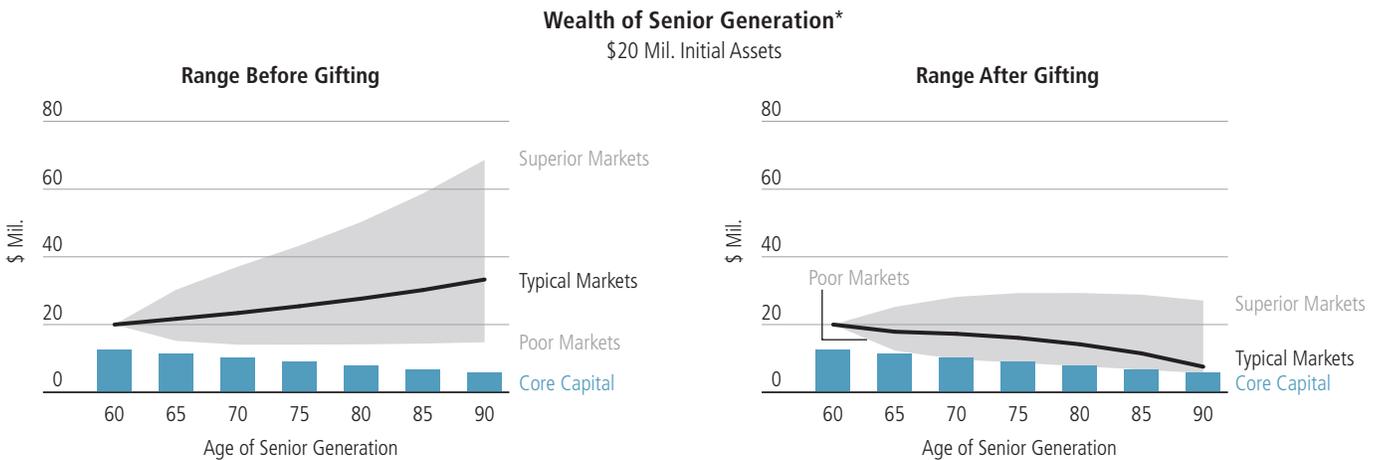
Now, let's say the senior generation want to move a targeted amount to their two children to supplement their retirement income. In typical markets, after 20 years the funds in the IDGTs for the children (\$3.4 million), plus the funds in the dynasty trust (\$6.1 million, from which distributions to the children could be made), total \$9.5 million—enough to fund approximately \$200,000 for each of the two children in annual spending over 30 years with a 90% level of confidence.

On the other hand, the primary goal may be to provide for the grandchildren by helping them buy homes or pursue whatever career options they desire. If so, in 20 years the senior generation can make just over \$11 million available to them (or almost \$2 million per grandchild), i.e., the total

<sup>20</sup> Moreover, once funds are in the IDGT, they represent a kind of "war chest" that provides the trustee with the flexibility to engage in a host of additional, more complex wealth transfer strategies, including buying assets from the grantor without causing the grantor to realize any capital gain (because the IDGT is "ignored" for income tax purposes). This might include an installment sale by the grantor of liquid or illiquid assets to the IDGT (see "Giving to Grandchildren and Beyond," on page 32, and "A Closer Look: Wealth Transfer with Illiquid Assets," on page 36, for more on installment sales and illiquid assets).

<sup>21</sup> In fact, a number of states have eliminated what's known as the "Rule Against Perpetuities," a complicated legal rule that limits the length of time most trusts can continue. In these states, one can create a GST-exempt trust (commonly known as a "dynasty trust") that theoretically can last "forever." As used in this research study, the term dynasty trust refers to any GST-exempt trust designed to last as long as the law allows.

**Can only tax-free gifts to IDGTs reduce a \$20 million estate to core capital?**



\*After spending, taxes, and inflation. Here and for similar cases analyzing the wealth of a family's senior generation, unless stated otherwise, the allocation of the senior generation is 60% stocks and 40% bonds; the allocation of the IDGTs for the children is 80% stocks and 20% bonds; and the allocation of all other trusts is 100% equities. Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. "Superior markets" represent results at the 10% level of confidence in our Wealth Forecasting model; "typical markets," the 50% level of confidence; and "poor markets," the 90% level of confidence. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details. Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

amount in the IDGTs for the grandchildren and the dynasty trust. However, if the senior generation want to provide supplemental retirement income for the children as well as help the grandchildren buy a first home, or if they want to do more for either group, they'll need to transfer even more wealth in a tax-efficient manner.

**Giving Away the Estate**

Now let's look at the other side of the coin—the grantor's estate. What if the senior generation simply want to minimize estate taxes by reducing their estates to their core capital? Their ability to accomplish that goal depends on a number of factors, including their level of wealth, their spending, and the returns on their investments.

Here we show the impact on the senior generation's wealth before and after making tax-free gifts to IDGTs (*Display 19*). We assume they start with \$20 million and spend at a rate of 2% of their initial assets, grown with inflation. They make annual exclusion gifts to IDGTs for their two children, their two children-in-law, and their six grandchildren, and they transfer \$2 million to a dynasty trust for their descendants. With \$20 million, it takes the senior genera-

tion just over 30 years to reduce their wealth to their core capital, in typical markets (*Display 19, right*). If markets happen to be particularly weak—say, at the 90th percentile of expected returns—it could take less than 10 years.<sup>22</sup> But if markets are strong, tax-free gifts to IDGTs alone simply won't do the job—the senior generation's estates will continue to grow unless they find additional ways to move the money.

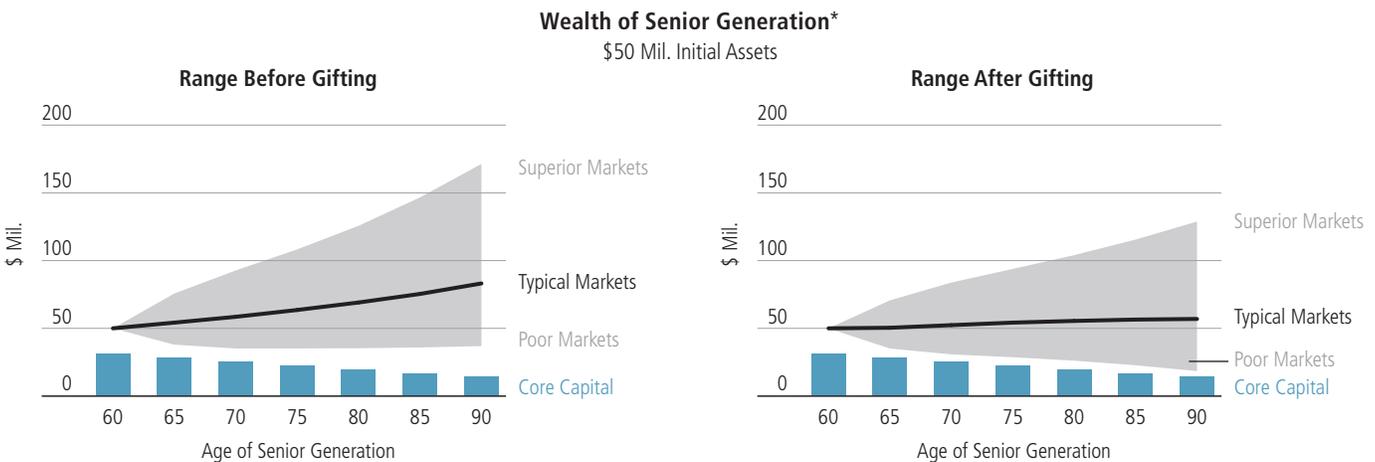
This is the fundamental limitation of basic gifts: Their ability to transfer wealth tax-free is constrained by the number of donors and donees. So if the senior generation's net worth is, say, \$50 million and they're spending at a rate of about 2% of their initial assets, a strategy that uses only basic gifts will have even less of an impact (*Display 20*). They'll need an additional tool or tools, regardless of the market environments they may encounter, to help them *scale up* both the amount and the pace of the wealth transfer.

**The Power of GRATs**

One strategy that can add significant power to a multigenerational wealth transfer plan is a GRAT, or grantor retained annuity trust. A GRAT can pass a portion of an asset's appreciation out of a donor's estate without any transfer tax.

<sup>22</sup> For purposes of this analysis, if at any point in any trial (of the 10,000 we modeled) the senior generation's estate is reduced to their core capital, they stop making annual exclusion gifts and "turn off" the grantor trust status of all IDGTs (so that those trusts thereafter pay their own income taxes).

**Can tax-free gifts to IDGTs reduce a \$50 million estate? Not in the donor's lifetime**



\*After spending, taxes, and inflation

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. “Superior markets” represent results at the 10% level of confidence in our Wealth Forecasting model; “typical markets,” the 50% level of confidence; and “poor markets,” the 90% level of confidence. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

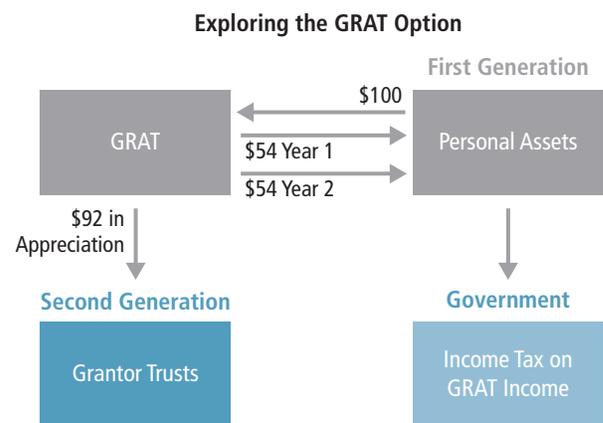
Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

Here’s a simplified example of how it works (*Display 21*). The grantor transfers assets to the GRAT—let’s say \$100—but retains the right to receive a fixed annuity payment from the GRAT each year during its term, which can be as short as two years.<sup>23</sup> Typically, the payments are set so that their present value when the GRAT is funded—discounted by the so-called Section 7520 rate—equals the amount transferred to the GRAT. (The Section 7520 rate is an interest rate published monthly by the IRS.)

In our hypothetical example, if the trust were established when the Section 7520 rate was 5.6%, the grantor would be entitled to a payment of about \$54 per year. Because the value of what the grantor retains equals the value of what he transfers, he makes no gift for gift tax purposes when he funds the GRAT. (Such a GRAT is said to be “zeroed-out.”) The GRAT succeeds if the assets in the trust produce a total return in excess of what’s needed to make the annuity payments to the grantor. For example, assume that the assets double in value (to \$200) by the end of the first year and that there is no growth thereafter. The grantor gets back \$108 in annuity payments, and the remaining \$92 is removed from his estate free of gift tax.

Our research shows that for volatile assets (such as publicly traded stocks), a series of short-term, zeroed-out “rolling GRATs”—wherein the annuities from one GRAT fund the next one, and so on—improves the likelihood and amount of wealth transferred versus a single, long-term GRAT. (See “A Closer Look: Rolling for Dollars—How Rolling GRATs Work,” following page.)

**Passing the buck: How a GRAT works**



Source: AllianceBernstein

<sup>23</sup> It might be legally permissible to establish a GRAT with a term of less than two years. However, for technical tax reasons, most planners do not feel comfortable with a shorter term. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

## A CLOSER LOOK: Rolling for Dollars—How Rolling GRATs Work

In a rolling GRAT strategy, the donor sets up a series of short-term (e.g., two-year) GRATs, using the annuity payments he receives each year to fund a new GRAT. He continues this process for as long as he wishes. By contributing each annuity to a new GRAT, he keeps the full amount committed to the strategy (say, \$10 million) at work, thereby leveraging the wealth transfer potential to its fullest. He also has several opportunities to move money through the strategy because the performance of each GRAT depends on the return of its investments over its two-year term.

To understand why this type of strategy tends to be a more powerful wealth transfer technique than a single long-term GRAT, consider the 10-year period between 1965 and 1974—the worst 10-year period for US stocks since the Great Depression. A 10-year zeroed-out GRAT invested in the S&P 500 would have had to outperform a hypothetical Section 7520 rate of about 5.2%, but the assets in the GRAT would have delivered a compound annual return of only about 1.2% (*display, lower right*).<sup>\*</sup> The beneficiaries would have wound up with nothing. These risks can be minimized by structuring the GRATs with shorter terms.

Consider how a series of two-year rolling GRATs would have played out in the same 1965–74 period. The key to the rolling GRATs is that they capture the inevitable short-term volatility of the capital markets. Even though stocks compounded at only about 1.2% annually over the period, their returns didn't move in a straight line. The two years 1967 and 1968 saw strong S&P returns, as did 1971 and 1972.

<sup>\*</sup> Section 7520 of the Internal Revenue Code became applicable in 1989. For this example, we created a proxy for the Section 7520 rate in prior years based on the IRS's current methodology.

<sup>†</sup> For illustrative purposes, this hypothetical example assumes a constant 5.8% 7520 rate.

And just a few strong years can be enough to spell success. As we saw, during that period a \$10 million 10-year term GRAT would have transferred no wealth. But two of the two-year rolling GRATs would have been successful, putting \$3 million in the hands of the beneficiaries (*display, far right*).

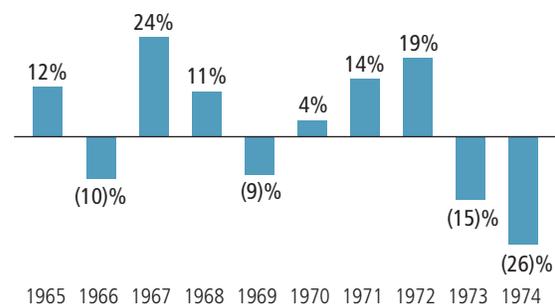
Indeed, simply capturing volatility is largely what drives the success of a rolling GRAT strategy. As a result, it effectively enables a grantor to move not only future appreciation out of his estate, but also a portion of the underlying assets committed to the strategy. For example, suppose a grantor commits an asset worth \$10 million to a series of two-year rolling GRATs. Suppose further that in the first year, the assets decline in value by 50%, to \$5 million. In the next year, the assets increase in value 100%, to \$10 million. The following year, the assets again decline in value to \$5 million, and so on, for a 10-year period. At the end of 10 years, the asset is still worth \$10 million—there has been no growth at all. However, the GRATs will have moved \$4.9 million out of the grantor's estate transfer-tax-free.<sup>†</sup>

### A long-term trust may not work in a poor market

#### GRATs and Hurdle Rate: 10 Dismal Years

Commitment to Rolling GRATs: \$10 Mil.

Initial Section 7520 Rate:	5.2%
10-Year S&P Compound Return:	1.2%
<b>10-Year GRAT Remainder:</b>	<b>\$0.0</b>



In fact, one way to enhance a rolling GRAT strategy is through “asset splitting.” Instead of setting up one two-year GRAT each year funded with a globally diversified portfolio of stocks, a grantor could set up, say, four—with each one housing a different asset class or style. For example, one series of rolling GRATs would be funded with US value stocks, another with US growth stocks, another with developed international markets stocks, and another with emerging markets stocks. The less diversified the assets in each series of GRATs, the greater the expected volatility and the better the results. ■

#### Rolling GRATs: Even a few good years are enough

Two-Year GRATs			
\$10 Mil. Initial Value, 100% US Equities			
	Section 7520 Rate	S&P Compound Two-Year Return	GRAT Remainder (Mil.)
1965–'66	5.2%	0.6%	\$ —
1966–'67	6.0	5.6	—
1967–'68	6.0	17.4	1.9
1968–'69	6.8	0.8	—
1969–'70	8.2	(2.5)	—
1970–'71	8.8	9.0	— <sup>‡</sup>
1971–'72	7.0	16.6	1.1
1972–'73	7.2	0.8	—
1973–'74	8.2	(20.8)	—

Two-Year Rolling GRATs Cumulative Remainder: \$3.0 Mil.

<sup>‡</sup>Although the GRAT's return was marginally above the Section 7520 rate, the annuity withdrawal after a year of underperformance versus the hurdle led to failure.

Source: Roger G. Ibbotson and Rex A. Sinquefeld, “Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns,” University of Chicago Press Journal of Business (January 1976); Standard & Poor's; and AllianceBernstein

Rolling GRATs are a very attractive wealth transfer strategy for a number of reasons:

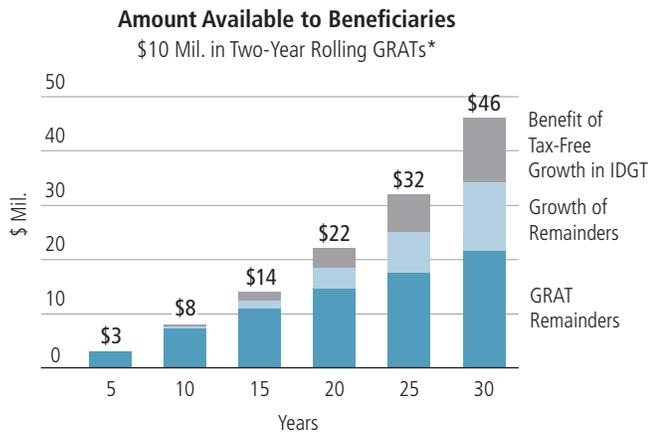
- **Scalability:** A donor can commit an unlimited amount to the strategy if he wishes to ramp up the potential wealth transfer.
- **Reliability:** While a two-year GRAT invested in a diversified pool of publicly traded stocks succeeds only a little under 60% of the time, the rolling GRAT strategy is almost certain to succeed. According to our research, the odds are about 95% that a rolling GRAT strategy will move at least some wealth out of the donor's estate in five years.
- **Flexibility:** Since the term of each GRAT can be as little as two years, the donor retains the flexibility to stop the strategy at any time or to commit fewer or more assets to the strategy each time he funds a new GRAT.
- **Limited financial downside:** The donor is no worse off financially if any individual GRAT fails, since he receives back all assets contributed to that GRAT.
- **Legal acceptability:** The legal requirements for creating a GRAT are described in detail in the Internal Revenue Code and applicable Treasury regulations.

Display 22, following page, shows how much wealth is transferred in the median case by a rolling GRAT strategy in which the assets remaining in any successful GRAT pass to and are held in a separate IDGT. The total wealth reflected by each bar in the display comprises the aggregate value of the assets received from the GRATs, the subsequent growth of those assets, and the portion of that growth that is attributable to the grantor's payment of the income taxes on the income from those assets.

Assuming a \$10 million commitment to the rolling GRAT strategy (and sufficient other assets to pay the income taxes on the income of the assets in the GRATs and IDGTs), a donor could expect to move \$8 million of inflation-adjusted wealth out of his estate in 10 years' time in typical markets. And the longer the strategy continues, the more powerful it becomes: In two decades, the strategy passes out

Display 22

**Rolling GRATs add significantly to a plan’s transfer potential...**



\* Median results; after inflation

All accounts are invested in 100% globally diversified equities. Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details. Source: AllianceBernstein

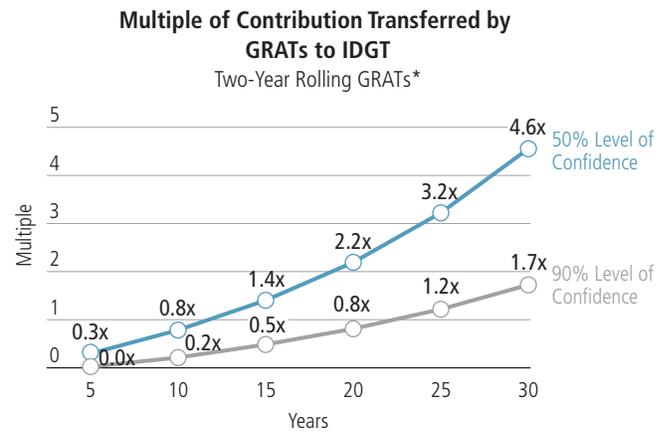
\$22 million in typical markets, and in three decades, a total of \$46 million—more than four times the amount committed to the strategy.

Display 23 illustrates how the amount transferred can be scaled up or down to meet various objectives. The blue line shows the multiple of any amount committed to the rolling GRAT strategy that a donor can expect to transfer, assuming typical markets, over various time periods. For example, if a donor wants to transfer a total of \$10 million over a 20-year period, he should commit about \$4.6 million of diversified equities to the strategy (the multiple 2.2 x \$4.6 million commitment = \$10 million transferred in 20 years).

We also present the transfer multiple (the gray line) assuming the grantor wants to plan with a much higher level of certainty—the 90% level of confidence. The data illustrate that even if markets perform exceptionally poorly, a donor who sticks

Display 23

**...and the donor can size the commitment to meet a specific wealth transfer goal**



\* After inflation

All accounts are invested in 100% globally diversified equities. Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details. Source: AllianceBernstein

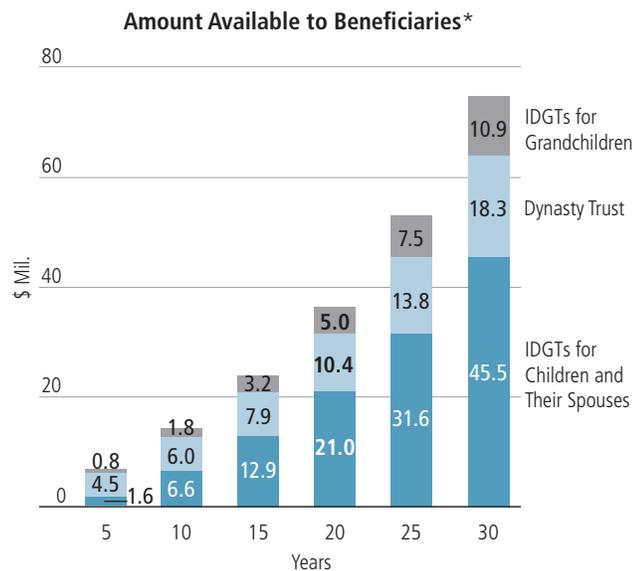
with the strategy over a 20-year period can still pass about 80% of the value of the funds he commits to the strategy. Specifically, to transfer \$10 million in 20 years with a 90% level of confidence requires a commitment of approximately \$12.5 million (\$10 million objective/0.8 multiple).

**Providing Defined Benefits with GRATs in the Mix**

Display 24 shows the overall wealth transfer if the senior generation in our example (again, assuming a family with 10 donees—two children, two children-in-law, and six grandchildren) combine basic gifts to IDGTs with a commitment of \$10 million to rolling GRATs.<sup>24</sup> With the addition of the rolling GRATs, the senior generation are better able to meet a variety of wealth transfer goals. In our previous example, they were able to make \$9.5 million available to the second generation in 20 years in typical markets using only annual exclusion gifts to IDGTs and transferring \$2 million to the dynasty trust. That would be enough to provide each of

<sup>24</sup> Note that because of a complex tax rule (known as the estate tax inclusion period or “ETIP” rule), GRATs are generally used to move funds only to the second generation. Donors can nevertheless pass a limited amount from the GRATs to a GST-exempt dynasty trust, which gives the family the flexibility to use those funds for the benefit of either the second or the third generation. Most planners agree that the amount that the rolling GRATs can effectively add to the dynasty trust is limited to the difference between the GST exemption and the gift tax exclusion—or about \$1 million per donor. In 2009, however, that amount is scheduled to increase to \$2.5 million per donor. For more on the ETIP rule, see footnote 30 on page 32. Our analysis assumes that the first \$2 million moved out of the senior generation’s estates through the rolling GRAT strategy is added to the dynasty trust (and that the senior generation’s remaining GST exemptions are allocated to that trust). All other funds moved out of the senior generation’s estates through the rolling GRAT strategy are added to the IDGTs for the children. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

**Combining gifts and GRATs to meet wealth transfer goals**



\*Median case, after inflation  
 Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 48–49, for further details.  
 Source: AllianceBernstein

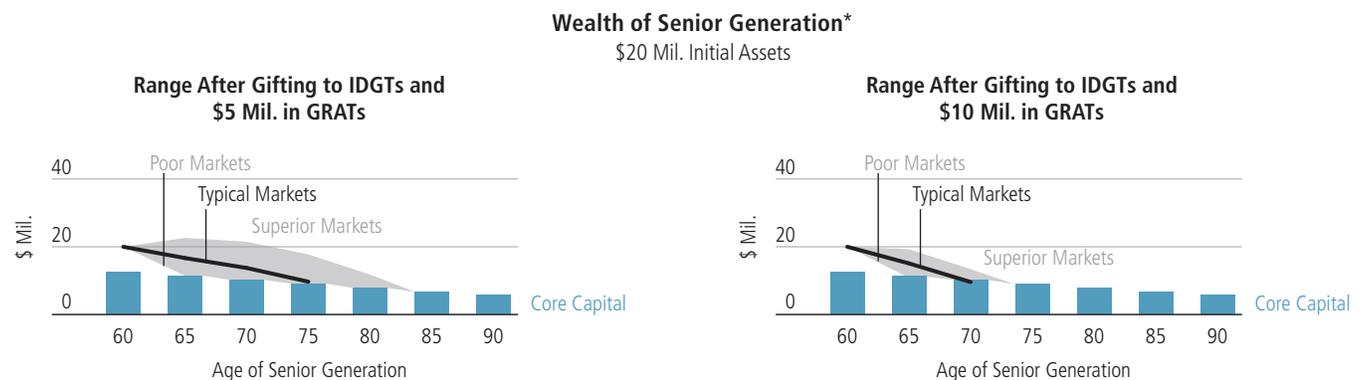
the two children with about \$200,000 per year to supplement their retirement needs. But by adding a commitment of \$10 million to a rolling GRAT strategy, the donors can make \$21 million available to the children from their IDGTs alone *without*

the need to make distributions to the children from the dynasty trust, thus allowing those funds to be used exclusively for the grandchildren. Previously, the grandchildren had only \$11 million available to them in 20 years’ time, providing a nest egg of just under \$2 million for each of the six grandchildren. Now, the funds in the dynasty trust and the IDGTs for the grandchildren total more than \$15 million in the same period. Without the GRATs, the family had to prioritize the gifts to either the second or third generation. With GRATs in the mix, they have enough to accomplish both objectives, and then some.

**Estate Reduction with GRATs: How Low Can You Go?**

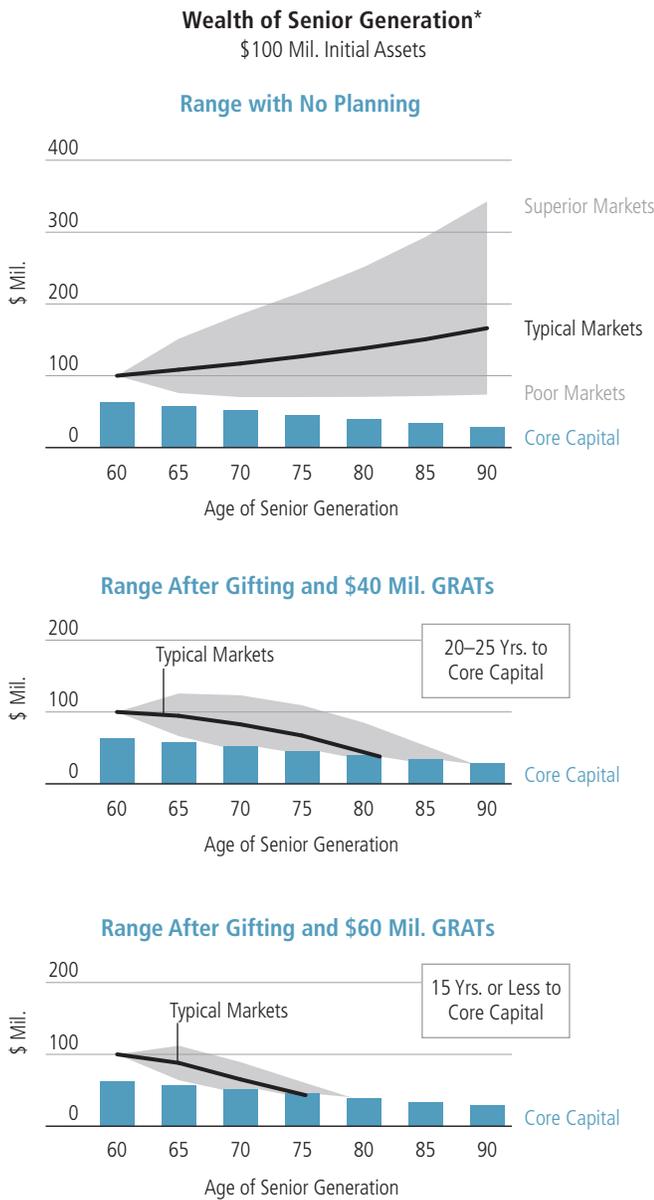
For a couple whose goal is to minimize estate taxes by reducing their wealth to their core capital, rolling GRATs can provide a very powerful solution. Let’s look again at the family with \$20 million, spending at a rate of 2% of their initial assets. Remember, the combination of basic gifts and IDGTs allowed the senior generation to reduce their wealth to their core capital in about 30 years in typical market conditions. Adding rolling GRATs enables them to accelerate the wealth transfer considerably and gives them more control over its speed. They can simply scale up or down the amount they commit to the GRATs, depending on the desired rate of transfer.

**The bigger the commitment to GRATs, the larger the estate reduction...and the faster it comes**



\*After spending, taxes, and inflation  
 For purposes of this analysis, in any trial (of the 10,000 we modeled) in which the sum of (a) the senior generation’s individually owned assets and (b) the amount in the GRATs falls below their core capital, the senior generation stop establishing new GRATs, stop making annual exclusion gifts, and “turn off” the grantor trust status of any grantor trusts. Moreover, the senior generation also reduce the amount contributed to new GRATs in any trial to the extent necessary to maintain their core capital in a 60/40 stock/bond mix. Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. “Superior markets” represent results at the 10% level of confidence in our Wealth Forecasting model; “typical markets,” the 50% level of confidence; “poor markets,” the 90% level of confidence. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.  
 Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

**Scaling up the transfer: These bedrock strategies can reduce even very large estates**



\* After spending, taxes, and inflation

Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. “Superior markets” represent results at the 10% level of confidence in our Wealth Forecasting model; “typical markets,” the 50% level of confidence; “poor markets,” the 90% level of confidence. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

For example, if their goal is to reduce their estates to their core capital at a faster pace, committing \$5 million to rolling GRATs will do it in about 15 years, in typical markets (*Display 25, preceding page*). If they want to do it even more quickly—say, in 10 years—committing \$10 million to GRATs will remove *all* of their excess capital, in typical markets. Once the senior generation reduce their estates to their core capital, they can stop making annual exclusion gifts, stop creating new GRATs, turn off the grantor trust status of the IDGTs, and essentially be done with lifetime wealth transfer, depending on market conditions or any change in their core needs.<sup>25</sup>

**Scaling Up the Transfer**

But what if the senior generation have a much greater amount of excess capital? Because of their scalability, GRATs can effectively reduce even a very large estate to core capital—and at a pace designed to suit the senior generation’s desires. For example, *Display 26* shows how a rolling GRAT strategy can be scaled up, almost without limit, to fully reduce an estate over different intervals of time. A 60-year-old couple starting with \$100 million, with a 2% spending rate, would see their wealth grow to almost \$170 million with no planning in typical markets. But with a comprehensive gifting strategy and by committing \$40 million to GRATs, they could bring their estates in line with their core capital in 20 to 25 years. And if they were older, or if for some other reason time were an issue, increasing the amount committed to GRATs to \$60 million would reduce their estates even more quickly—in 15 years or less. Depending on their preferences, we can pinpoint the optimal strategy, and they can alter it at essentially any point should their wishes or circumstances change.

In this case, committing \$60 million would require the senior generation to dip into their core capital to fund the GRATs. And that’s perfectly reasonable, to a point. It’s important to understand that a donor need not limit the amount he commits to rolling GRATs to his excess capital. The reason is

<sup>25</sup> Recall, however, that core capital is calculated based on very conservative estimates of market performance (i.e., returns at the 95% level of confidence). As a result, after the senior generation reduce their wealth to their core capital and stop the transfer of wealth, it’s highly likely that they’ll again have excess capital in the future. Consequently, they should regularly reconsider their estate plan and the family’s goals in the context of market performance. For more on this, see the section “Implementing, Monitoring, and Adjusting the Plan” on page 40.

that the annuity payments from a GRAT return to the donor all of the assets he transfers to the GRAT; it's only a portion of the appreciation during the GRAT's term that is removed from the donor's estate. If necessary, the donor can use the amount returned to him from a GRAT to meet his spending needs, rolling only the balance into a new GRAT. The key is simply to ensure that the donor's individual assets *plus* the amount in rolling GRATs never falls below his core capital figure.

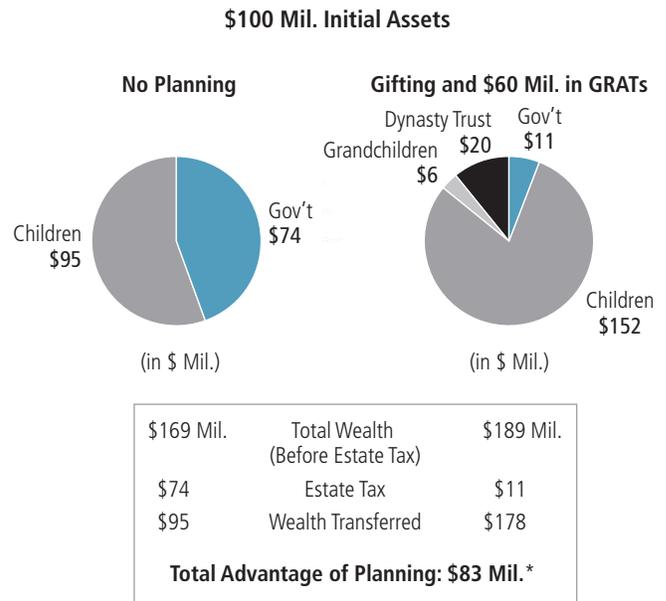
### Cashing Out: Planning's Benefits

So what does this achieve? Consider two scenarios, before and after the impact of estate tax. In one, the senior generation do no planning, and in the other, they engage in the strategies outlined above (*Display 27*). Without planning, the couple's \$100 million estate (invested 60/40) grows to almost \$169 million in typical markets. Upon the survivor's death, the government gets a little under half, or \$74 million, leaving \$95 million for the couple's children. On the other side, by virtue of planning, the family has allocated its excess capital more aggressively, bringing the family's pre-estate-tax wealth to \$189 million—an increase of \$20 million. Then, by making basic gifts to IDGTs and committing \$60 million to rolling GRATs, the couple move nearly all of their excess capital out of their estates in the median case, leaving a vastly reduced estate upon the survivor's death. The result is estate taxes of just \$11 million—that's about \$63 million in tax savings—with the remainder (about \$178 million) accruing to the younger generations. In sum, planning has added about \$83 million in value.<sup>26</sup>

As we've shown, irrespective of a family's wealth or goals (whether they prefer transferring defined amounts to designated beneficiaries or simply want to reduce their estates quickly to their core capital), a transfer plan that combines basic gifts, IDGTs, and rolling GRATs can be as simple as it is effective. ■

Display 27

### Effective planning can create outsize value



\*Mortality-adjusted. Assumes that the spouses die in same year, and that an inflation-adjusted \$2 million per person is exempt from estate taxes. In the case where there is estate planning, we further assume a \$2 million initial gift to the GST-exempt trust and that the first \$2 million in remainders from GRATs go to the GST-exempt trust. This reduces the remaining estate tax exclusion in this case to \$2 million for the couple. Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

<sup>26</sup> This analysis assumes that, in the scenario in which the senior generation engage in no lifetime wealth transfer, their remaining assets after estate taxes pass to their children. In the scenario in which they do engage in lifetime wealth transfer, their remaining assets after estate taxes are added to the trusts for their children.

## THE MORTALITY GAP: WHAT IF DEATH INTERVENES?

*Had we but world enough, and time...*

Andrew Marvell

Most lifetime wealth transfer strategies take time to work, and this can present a significant problem: If the senior generation should die before they are able to move the desired funds to their beneficiaries, the plan will fail to accomplish many of their objectives, including minimizing estate taxes to the greatest extent possible. How can families bridge this mortality gap?

### Hedging Against the Risk of Early Mortality

For many families, life insurance plays a key role in providing income replacement to loved ones in the event of the premature death of a breadwinner. But for many wealthy families, income replacement is of limited importance—it's insuring against the risk of a large estate tax at the death of the surviving spouse that's paramount. Life insurance can play a role in hedging against that risk.

For example, families with substantial *illiquid* holdings often rely on life insurance. A typical scenario involves the owner of a closely held business who wishes to transfer the business intact to his children. In such a case, the senior generation may wish to use a “second-to-die” life insurance policy to fund all or some portion of the estate tax attributable to the business to avoid its forced sale to cover the tax.

Likewise, a family with a large *liquid* estate may use insurance to reduce the risk that the premature death of the senior generation will preclude them from transferring sufficient wealth during their lifetimes. After all, if the senior generation can't continue basic gifts, GRATs, and IDGTs for long enough, they may fail to reduce their estates to their core capital. That's where life insurance might kick in to replace some of the funds lost to estate taxes.

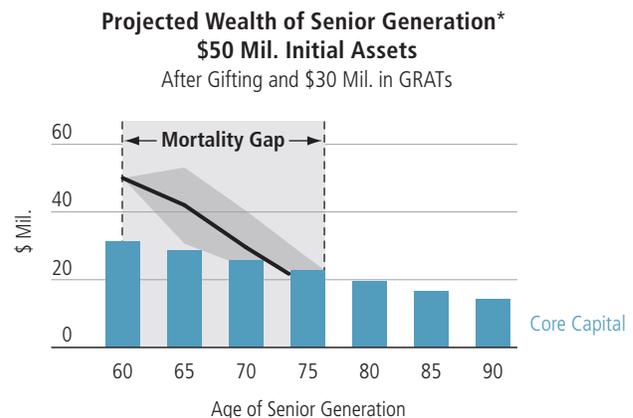
Here's how such a plan might work: Instead of making all of their annual exclusion gifts to IDGTs for the younger generations, the senior generation make some of those gifts to an *irrevocable life insurance trust* (ILIT). The trustee of the ILIT then uses those funds to pay premiums on a second-to-die

life insurance policy on the senior generation's lives. Because the policy is owned by the ILIT, the death benefit is not includable in the senior generation's estates. The trustee can buy a policy with a death benefit sufficient to cover the estimated estate tax that would be due upon their early deaths—levied on both the remaining “excess capital” and their higher-than-anticipated core capital. To keep the cost of the insurance down, the policy might have a declining death benefit that expires at some predetermined point in the future—ideally, at around the time when the gifts, GRATs, and IDGTs are likely to have succeeded in removing all of the excess capital from their estates.

Consider our previous example: a married couple aged 60 (with two children, two children-in-law, and six grandchildren—a total of 10 donees) who have \$50 million and spend \$1 million annually. They have embarked on a multigenerational wealth transfer plan that includes basic gifts, IDGTs, and \$30 million in rolling GRATs, which should allow them to reduce

Display 28

### The mortality gap: Even aggressive strategies require time to work



\*After spending, taxes, and inflation

Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. “Superior markets” represent results at the 10% level of confidence in our Wealth Forecasting model; “typical markets,” the 50% level of confidence; “poor markets,” the 90% level of confidence. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

their estates to their core capital in less than 20 years no matter what markets they see (*Display 28*). Accordingly, the insurance policy should continue for only 20 years—after that point, their mortality is unlikely to result in any avoidable estate tax hit.

Looking at our projections, the wealth transfer strategy they’ve chosen will effectively “freeze” the value of their estates at around \$50 million, with the value declining progressively to their core capital. Assuming an estate tax rate of 45%, the family might consider purchasing a policy of around \$30 million to cover the tax if they should die early. (This amount is more than the \$25 million or so needed *today* to address the potential estate tax burden, but it provides the ILIT with some cushion to account for the impact of asset growth and inflation over time.)

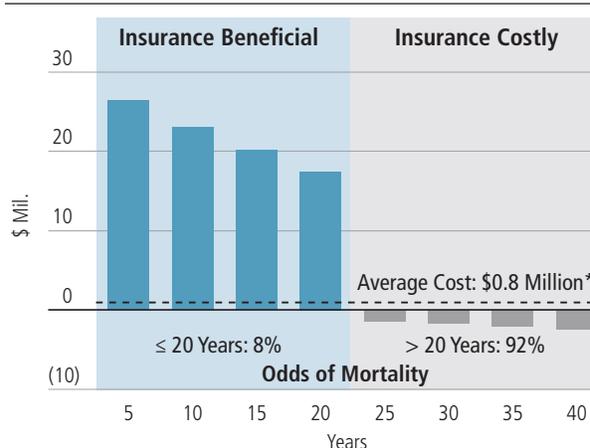
Based on representative product and pricing in the life insurance industry, the family might be able to purchase such a second-to-die policy (with a death benefit of \$30 million that would expire in 20 years) for an annual premium of about \$70,000.<sup>27</sup> If they use a portion of the \$240,000 in annual exclusion gifts they can currently make (i.e., \$12,000 x 10 beneficiaries x two parents) to pay this annual premium, they still currently have about \$170,000 each year to give to the IDGTs for the second and third generation to invest in the capital markets.

*Display 29* illustrates the pros and cons of buying the insurance policy based on different mortality dates. If both spouses die early (during the 20-year period that the policy is in force), the insurance really pays off—resulting in roughly \$20 million more in inflation-adjusted wealth in the median case than if the senior generation had just made basic gifts to IDGTs, and allowing the senior generation to move their wealth effectively intact to their descendants.

But the actuarial likelihood of such an early death is only about 8%. If at least one spouse lives past 20 years—which has a 92% probability of occurring—the surviving spouse will die after the insurance has been discontinued. In that case, the family would have been better off had the senior generation made

Display 29

### The benefits and costs of insurance



\*Mortality-adjusted; after inflation

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent any past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

all annual exclusion gifts directly to the IDGTs for their descendants (which would have invested the gifts in the capital markets) rather than making those gifts to the ILIT (where the money went to the insurance company). The inflation-adjusted cost, on average, is about \$800,000. With these trade-offs in mind, the family and their advisors can decide whether having the peace of mind that the premature deaths of the senior generation won’t derail the family’s wealth transfer goals is worth the price.

We should note that many investors take a different tack when it comes to incorporating insurance into their wealth transfer plans. They establish an ILIT that buys a policy with a death benefit that is as large as possible, contributing *all* of their potential annual exclusion gifts to the ILIT to pay for the insurance and making none of them to their descendants. Often they eschew *all* other wealth transfer strategies and make the ILIT the centerpiece of the plan. And unlike the insurance policy described above, which is designed to protect against a temporary risk, this one is designed to remain in force at the death of the surviving spouse, regardless of when that death occurs.

<sup>27</sup> There is substantially no accumulation value or cash-surrender value in the policy that we are modeling. This illustration assumes a second-to-die policy with a secondary no-lapse guarantee. The insureds were assumed to be 60-year-old residents of the state of Illinois, each in the highest medical underwriting category. Further information regarding this illustration is available upon request.

While this may prove to be wise, it is really more an investment decision than an estate planning decision. If the surviving spouse dies earlier than expected, the policy will deliver a high return on investment. If, on the other hand, at least one of the insureds lives a long life, the return on the policy becomes less appealing. Each policy has a “cross-over” point at which the cost of the premiums builds to such an extent that the family would have been better off just investing in the markets. Quantitative analysis can help the family make a rational decision regarding whether to purchase insurance, and if so, how to optimally size the policy, based on a rigorous review of the data.

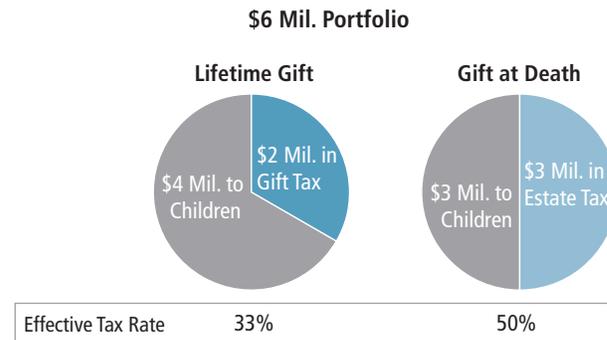
### Paying Gift Tax: A Better Strategy for Those in a Rush?

Up until now, we’ve considered only strategies designed to transfer wealth gift-tax-free. This begs the question: Would it ever make sense for a wealthy donor to purposely pay gift taxes? Although most donors are loath to pay gift tax, it might be a better option for a donor with a short time horizon—a very elderly donor, for example. The reason is that the gift tax is computed on only the amount received by the donee, while the estate tax is due on the entire estate (including the assets in the estate used to pay the estate tax).

For example, consider a donor with \$6 million (*Display 30*). If she gives these assets to her children at her death, \$3 million will be due the government. (For simplicity’s sake, we disregard the estate tax exclusion and assume a flat 50% estate tax rate.) However, if she gives those assets to her children during her lifetime, she can move \$4 million to them because she owes gift tax only on that amount—in this case, a tax of \$2 million on the gift. That makes the effective gift tax rate only 33% instead of 50%, assuming the donor lives for three years after the gift. (If she doesn’t, the gift tax is includable in her estate for estate tax purposes, and the payment of the gift tax results in no overall tax savings.) While the analysis is sometimes a bit more complex, this example illustrates the potential benefit of paying gift taxes.

Display 30

### Does it ever pay to pay gift tax?



Source: AllianceBernstein

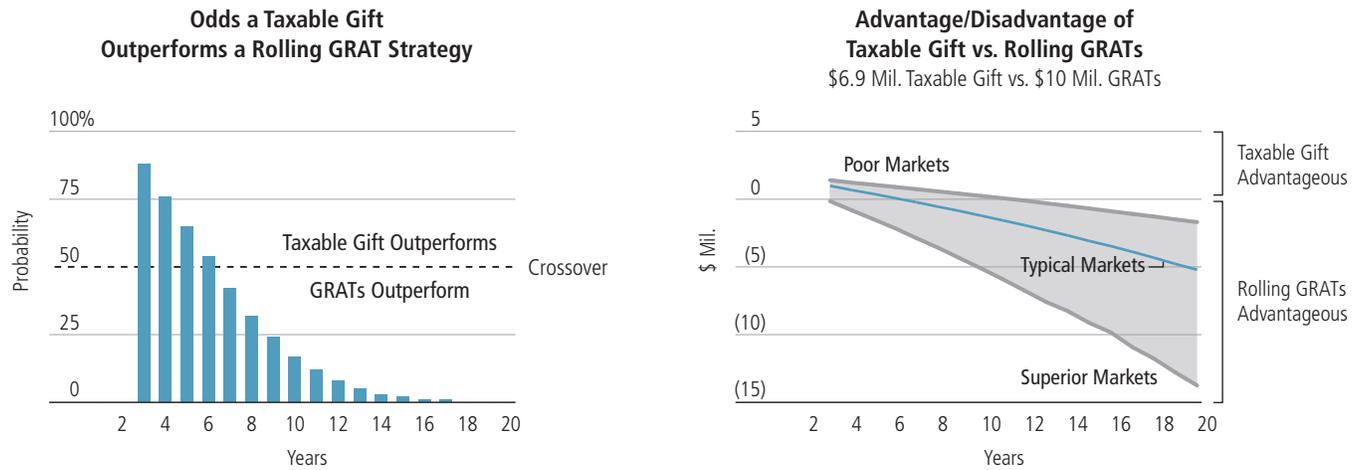
Our Wealth Forecasting System can help a donor determine whether paying gift taxes is more attractive than an alternative strategy like rolling GRATs. Consider an investor who wants to move \$10 million out of his estate. We compared two strategies: (1) giving \$6.9 million directly to his children and paying \$3.1 million of gift tax, versus (2) committing the full \$10 million to rolling GRATs.<sup>28</sup> In the latter strategy, we assume that the remaining property in any successful GRAT passes to an IDGT for the children, and that the income taxes on both the GRATs and the IDGT are paid from the GRAT annuities, with only the balance of each annuity payment rolled forward into a new GRAT.

We analyzed the impact on the total wealth in the hands of the next generation—after imposing estate taxes on all assets remaining in the GRATs that hadn’t been transferred. We found that in the median case, the rolling GRAT strategy beats the outright gift and payment of gift tax in about six years. Considering that the grantor must live for at least three years after an outright gift for the payment of gift taxes to reduce the family’s overall tax burden, the period during which paying the gift taxes is likely to be better than the rolling GRATs narrows from six years to only three (*see Display 31, left*). In other words, paying gift taxes is likely to be preferable in only a very limited number of cases.<sup>29</sup>

<sup>28</sup> We assume the gift is taxed at a 45% rate and that the donor has no remaining gift tax exclusion.

<sup>29</sup> Indeed, even if the gifts are made with assets subject to a 30% “valuation discount,” the crossover point lengthens to only about nine or 10 years.

**Taxable gifts vs. GRATs: What's the best approach?**



All accounts are invested in 100% globally diversified equities.  
 Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.  
 Source: AllianceBernstein

Moreover, the investor can make the rolling GRAT strategy even more attractive by scaling up the amount committed. For example, even though he wants to move only \$10 million out of his estate, he could still commit \$20 million (or more) to GRATs, provided he has those funds. He would move more out of his estate sooner, and the strategy could be discontinued when \$10 million had been transferred. This would reduce the crossover period versus the outright gift to just four years.

Furthermore, as seen in *Display 31, right*, the benefits are skewed in favor of the rolling GRAT strategy. That's because with an outright gift, the most a grantor can save is the difference between the 33% and 50% effective tax rates (as illustrated in *Display 30*). On the other hand, if the GRATs are really successful, the grantor can reduce the tax on the transfer of wealth even further—to as little as nothing. So while paying some gift taxes might make sense for an elderly donor, for most, a rolling GRAT strategy will be a more attractive strategy. ■

## BUILDING ON BEDROCK FOR GENERATIONS TO COME: MULTIGENERATIONAL SOLUTIONS

*A good man leaveth an inheritance to his children's children.*

Proverbs 13:22

For all the attractiveness of the “bedrock” mix of basic gifts, GRATs, and IDGTs, it is not a panacea. This is particularly true for a very wealthy family with long-term multigenerational aspirations for their wealth. In such cases, the senior generation may wish to expand upon these bedrock strategies to accomplish, for example:

- **Large transfers to the third generation (and beyond):** Most planners agree that GRATs are of limited use in adding funds to a GST-exempt trust designed to move wealth to grandchildren or more remote descendants. One solution often used to move more wealth to remote descendants is an installment sale to an IDGT.
- **Illiquid transfers:** The assets of many wealthy families consist largely of closely held businesses or commercial real estate. These assets are illiquid and present unique challenges and opportunities when it comes to transferring them to descendants.
- **Multigenerational family philanthropy:** For families who have significant charitable intent, a private foundation is often the vehicle of choice for passing on both the dollar value of their estates and their philanthropic values.

In this section, we explore the pros and cons of the strategies typically used to address each of these issues.

### **Giving to Grandchildren and Beyond: Installment Sales to IDGTs**

As we’ve discussed, given enough time, GRATs can efficiently move an unlimited amount of liquid wealth to the second generation. However, most planners agree that their ability to transfer funds beyond that generation, into a long-term GST-exempt trust that can benefit grandchildren or more remote descendants, is constrained.<sup>30</sup> Transferring funds into such a dynasty trust is in many ways the

holy grail of estate planning, since those funds conceivably can escape transfer taxes forever. With this in mind, some practitioners believe that another wealth transfer technique—known as an installment sale to an IDGT—should always be a part of a wealthy family’s estate plan. If this strategy succeeds, any wealth it moves can build inside a family’s dynasty trust.

To understand the role that an installment sale may play, let’s first review the mechanics of the strategy. The senior generation sells assets to an IDGT in exchange for a promissory note from the trustee. The note obligates the trust to repay the grantor the full value of the assets sold, plus interest usually set at a statutory rate known as the Applicable Federal Rate (AFR). To ensure that the strategy is respected for tax purposes, most planners recommend that the trust already hold assets equal to at least 10% of the total value of the assets.<sup>31</sup> So if the IDGT doesn’t already have sufficient assets, the grantor must make an initial “seed” gift to support the purchase of the assets. The strategy succeeds if the assets sold to the IDGT produce a return in excess of the interest rate payable under the note; any excess appreciation can stay in the IDGT for the beneficiaries.

An installment sale to an IDGT has several potential advantages over a GRAT.

1. **Lower “hurdle rate”:** The interest rate on the note (i.e., the AFR) is generally lower than the Section 7520 rate used to value a GRAT’s annuity. This means that the return that the assets must produce for the strategy to be successful is lower.
2. **Deferral of principal repayment:** The principal can be repaid as a balloon payment at the end of the note term. As a result, the annual interest payments to the grantor are smaller than the annuity payments from a GRAT of an equivalent size and

<sup>30</sup> One major drawback of a GRAT is that it does not easily permit a grantor to leverage his GST exemption. The reason is that if a grantor dies during the term of a GRAT, all or a portion of the value of the GRAT assets will be includable in his estate for estate tax purposes. As a result, the annuity term of the GRAT is what is known as an “estate tax inclusion period” (ETIP), and the law effectively prevents the allocation of a GST exemption to a trust while it is subject to an ETIP. As a practical matter, this means that a grantor cannot effectively allocate any GST exemption to a GRAT until the end of its annuity term. This limits the total amount that can pass from a GRAT to a trust meant to provide transfer-tax-free distributions to the grantor’s grandchildren or more remote descendants to the grantor’s unused GST exemption when the GRAT terminates.

<sup>31</sup> Although the general rule under prevailing practice appears to be 10%, no tax or legal authority expressly sanctions 10% as a necessary or sufficient amount.

term. This allows more of the assets to remain in the IDGT longer to produce a return in excess of the interest due the grantor.

3. **Greater flexibility:** The trustee could choose to pay off the note at any time or even renegotiate its terms. Also, the beneficiaries can receive distributions from the IDGT before the note is fully repaid; with a GRAT, they must wait until the annuity term ends.
4. **Reduced mortality risk:** If the grantor dies during the term of the note, only the unpaid principal balance of the note is includable in the grantor's estate for estate tax purposes.<sup>32</sup> By contrast, if a grantor dies during the term of a zeroed-out GRAT, it is likely that the entire value of the GRAT's assets will be includable in the grantor's gross estate.
5. **Greater leverage of GST exemption:** Perhaps most important, the grantor can allocate his GST exemption to the amount he uses to seed the IDGT. And because the installment sale is not considered an addition to the trust for GST tax purposes, any excess appreciation transferred to the IDGT as a result of the sale will also be GST exempt.

However, the installment sale also has a few significant drawbacks.

1. **Legal uncertainties:** Unlike a GRAT, an installment sale is not explicitly sanctioned under the tax laws, and many planners therefore believe that it results in more legal and tax uncertainties than a GRAT.
2. **Economic downside risk:** Because an installment sale requires a "seed" gift, there is an important economic risk: If the strategy fails, the grantor wastes some of his gift tax exclusion or returns to his estate property that he has otherwise already successfully transferred.

3. **"Rolling" installment sales not feasible:** Because the grantor must use his gift tax exclusion (or pay gift tax) to seed an IDGT, a series of short-term "rolling" sales to an IDGT is infeasible.<sup>33</sup>

This last drawback, the impracticability of establishing a series of short-term, rolling sales to an IDGT, particularly detracts from its effectiveness as a wealth transfer strategy relative to rolling GRATs. To illustrate, we compared the following three strategies:

- A nine-year series of two-year rolling GRATs;
- A nine-year installment sale to an IDGT with marketable securities; and
- A nine-year installment sale to an IDGT with a family limited partnership (FLP) interest, subject to a 30% discount.<sup>34</sup>

For the installment sales, we assume a \$1 million "seed" gift and an additional \$9 million sale to the IDGT, for a total transfer of \$10 million to the trust. For the rolling GRATs, to provide an apples-to-apples comparison, we assume that the grantor commits \$9 million to the GRATs and makes a separate gift of \$1 million to an IDGT (to which no sale is made). We also assume that the assets remaining in any successful GRAT are added to the separate IDGT. In all cases, we assume that the assets are invested in a globally diversified equity portfolio.<sup>35</sup>

The results (*Display 32, following page*) show that rolling GRATs yield significantly better results than the sale of the equities to an IDGT. In the median case, the advantage amounts to \$3 million—\$7.7 million versus \$4.7 million. And the GRAT strategy also provides \$2 million more in downside protection.

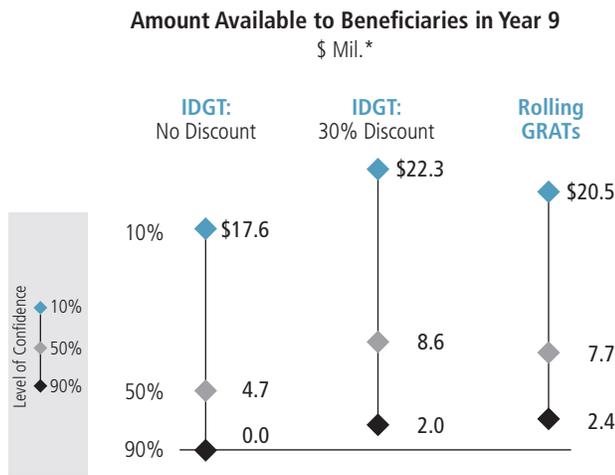
<sup>32</sup> However, the law is unclear regarding the income tax consequences if the grantor dies while the note is outstanding. For example, it is possible that the IRS would take the position that the grantor's death results in capital gain to the grantor or his estate.

<sup>33</sup> For example, assume that a grantor uses his \$1 million gift tax exclusion to fund an IDGT with equities and sells an additional \$9 million of equities to the IDGT in exchange for a two-year note that pays interest only at the AFR (e.g., 4.11%) and a balloon payment of principal. Our analysis shows that the grantor will receive back at least a portion of his \$1 million "seed" gift more than one-third of the time.

<sup>34</sup> We assume that the FLP holds globally diversified equities and that distributions from the FLP to the IDGT enable the IDGT to satisfy all payments on the note to the grantor. An installment sale of an interest in an FLP to an IDGT may involve a number of legal and tax risks and uncertainties that a GRAT funded with marketable securities would not have. Bernstein is not a tax or legal advisor. Any grantor considering the use of an FLP in connection with his or her estate planning should consult his or her tax or legal counsel.

<sup>35</sup> Our analysis assumes that the promissory note provides for annual interest payments at an AFR of 4.72% and a balloon payment of principal at the end of the note's term. The initial Section 7520 rate for the GRATs is 5.8%.

**Rolling GRATs vs. installment sale to an IDGT**



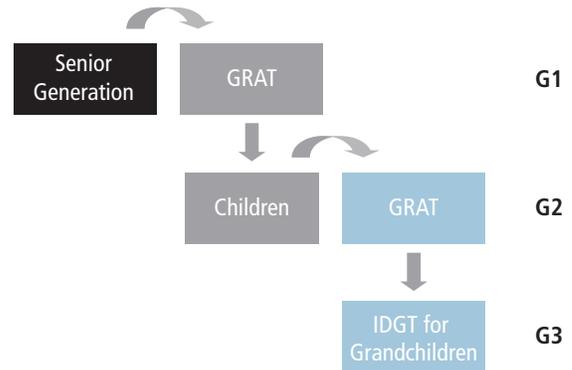
\*Median results; all accounts are invested in 100% globally diversified equities. Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details. Source: AllianceBernstein

Not surprisingly, the sale of the discounted FLP interest to the IDGT compares more favorably. Assuming that the interest is subject to a 30% discount, we estimate that the IDGT would be left with about \$8.6 million in the median case, almost \$1 million more than the GRAT strategy.<sup>36</sup> And on the downside, the result is only slightly worse than with the rolling GRATs: \$2.0 million versus \$2.4 million. Of course, the key difference is that all of the funds moved by the installment sale could be distributed to the grandchildren transfer-tax-free. By contrast, with the rolling GRAT strategy, only the funds attributable to the outright gift to the IDGT (about \$1.6 million of the \$7.7 million in the median case) are GST exempt.

**Another Idea: “Intergenerational” GRATs**

But given some of the potential difficulties and uncertainties of the installment sale to the IDGT, a grantor should not lose sight of the fact that a family committed to tax-efficient wealth transfer may be able to move significant funds to grandchildren, and beyond, even without the strategy. Specifically, a cooperative family could consider implementing

**Intergenerational GRATs: A better way?**



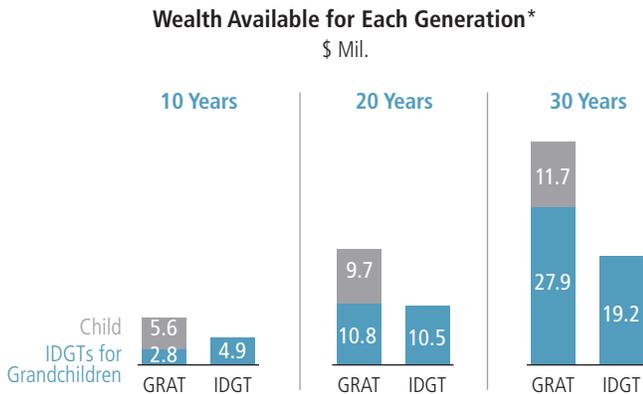
Source: AllianceBernstein

a series of what we might call “intergenerational” GRATs as an alternative. Here a grantor (G1) commits assets to a rolling GRAT strategy, wherein the remainder of any successful GRAT is paid to the grantor’s child (G2). The child then commits any amount she receives to her own rolling GRAT strategy. The remainder of any successful GRAT established by the child passes to an IDGT for the first grantor’s grandchildren (G3) (Display 33).

We compared the amount of money that could be moved to grandchildren through either a 20-year installment sale to an IDGT or a 20-year intergenerational GRAT strategy.<sup>37</sup> The results show that the GRAT strategy moves slightly more wealth to the grandchildren in the median case (Display 34). The advantage is about \$300,000 on an inflation-adjusted basis: \$10.8 million versus \$10.5 million. Also, intergenerational GRATs provide substantially more protection on the downside: At a 90% level of confidence, the IDGT would have failed altogether, transferring no funds, while the GRAT strategy would have passed almost \$3.3 million to the grandchildren. Moreover, with the rolling GRAT strategy, a substantial portion of the initial \$10 million committed to the strategy has also been moved out of the grantor’s estate and into the child’s estate—about \$9.7 million in the median case. As a result, the grantor is left with

<sup>36</sup> This assumes that the FLP is liquidated after the note is repaid.  
<sup>37</sup> For the installment sale, we assume a \$1 million gift and an additional \$9 million sale to the IDGT, for a total transfer of \$10 million to the trust. For the intergenerational GRAT strategy, we assume that the grantor commits \$9 million to rolling GRATs and makes a separate gift of \$1 million to an IDGT for the benefit of his grandchildren (to which no sale is made). Any assets remaining in any successful GRAT pass to the grantor’s child, who also commits them to a rolling GRAT strategy, and any assets remaining in any successful GRAT established by the child pass to a separate IDGT for the benefit of the grandchildren. In both cases, we assume that the assets are invested in a globally diversified equity portfolio.

**Gauging long-term transfer potential: intergenerational GRATs vs. installment sale to IDGT**



\*Median results, after inflation; all accounts are invested in 100% globally diversified equities.  
 Long-term Applicable Federal Rate used in installment sale to IDGT cases was 5.09%. The initial 7520 rate was 5.8% in this analysis.  
 Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.  
 Source: AllianceBernstein

only \$4.8 million from the original \$10 million. By contrast, the installment sale to the IDGT leaves the grantor with about \$14.8 million. Thus, the intergenerational GRAT strategy also does a much better job of helping the grantor reduce his estate.

The point is, due to their scalability and flexibility, rolling GRATs may have applications in areas where they have traditionally been excluded or overlooked, including moving wealth to grandchildren.

**Multigenerational Philanthropy: Passing On Value—and Values**

There are many ways to give philanthropically: Donors can give directly to charity either during their lifetimes or at their deaths, or they can give through special tax-advantaged vehicles, including certain trusts. Since a charitable gift can be made free of gift or estate tax, determining how to proceed hinges more on the emotional benefits that different forms of giving might offer and the potential income tax savings. These savings may include a large up-front income tax deduction, a tax-advantaged environment in which to grow the gifted assets, an efficient vehicle for portfolio diversification, or a mechanism for leveraging multigenerational giving.

Determining which strategy is right for a given donor depends on his unique circumstances and objectives. (For a comparison of the salient characteristics of a broad sample of charitable giving strategies, see *Display 35*.) For example, a donor with the dual goals of establishing a regular income stream for himself and leaving a charitable legacy may find a charitable remainder trust appealing, particularly if he owns large amounts of low-basis stock, which can be diversified inside the trust with the capital gains taxes deferred. On the other hand, for a donor who’s interested in transferring wealth to descendants transfer-tax-free—and who’d like to begin gifts to charity now—a charitable lead trust may be appropriate.

**Structured-giving alternatives to direct charitable gifts: a representative sample**

Vehicle	When Charity Receives Gift	Tax-Free Environment	Personal Income Tax Deduction	Other Key Benefits
Private Foundation	Beginning now, over time	Yes*	Generally, based on fair market value of gift	Control and multigenerational legacy
Public Charities (Donor-Advised Funds, Supporting Organizations)	Beginning now, over time	Yes	Generally, based on fair market value of gift	Donor has no administrative responsibilities
Charitable Remainder Trust (CRT)	At expiration of CRT	Yes, but distributions may result in income to recipient	Limited to present value of remainder interest when CRT is established	Income stream to donor
Charitable Lead Trust (CLT)†	Beginning now, over a fixed period of years	No‡	No	Potential tax-free transfer to children

\*There is an excise tax of 1%–2% on net investment income.  
 †Assumes a non-grantor CLT  
 ‡A CLT generally receives a tax deduction each year equal to the lesser of the contribution to charity or the trust’s income.

## A CLOSER LOOK: Wealth Transfer with Illiquid Assets

So far we have been assuming that the senior generation's wealth consists largely of liquid assets. But many families hold illiquid assets, such as a closely held business, commercial real estate, or an interest in a private partnership. These present different challenges—and opportunities—when transferring wealth.

The issue is that these assets are, well, illiquid: They are not marketable securities priced daily in public exchanges, but holdings that are priced only as specific needs dictate, with the help of a valuation expert who analyzes market comparables or discounted cash flows.

Nevertheless, this constraint enables owners of illiquid assets to take advantage of several “leveraging” opportunities. They can benefit from valuation discounts on the assets (imposed due to lack of marketability or a minority interest status), strong or improving cash flows from the assets, and event-driven increases in their value. To capitalize on these leveraging opportunities, one simply needs to modify the wealth transfer strategies we have already discussed.

For example, basic gifts can easily be made with illiquid assets based on a recent valuation. But with a valuation discount, it's possible to leverage up the amount of property transferred. Consider a minority shareholder interest in a private company. If it is subject to a 30% valuation discount because of a lack of marketability and its minority status, the intrinsic value that can be sheltered from gift tax by the gift exclusion increases from \$1 million to \$1,428,571. That enables the senior generation to get more of the asset to the next generation faster.

### Are GRATs As Great for Illiquid Wealth?

With some modification, GRATs can also work well with illiquid interests. Specifically, donors may be able to take advantage of opportunities to transfer interests in illiquid assets by extending the GRAT term in anticipation of event-driven value increases. Consider the increase in value for a minority shareholder when a business is sold in its entirety for cash, thereby entitling the minority shareholder to a proportionate share of the full “enterprise” value of the business. For example, pre-IPO stock or stock in a private company that is expected to be sold for its enterprise value in a relatively short time might be contributed to a GRAT with a slightly longer term. In such cases, planning implemented in anticipation of the event can facilitate the transfer of all or a portion of that value increase to younger-generation beneficiaries without, or with reduced, transfer tax costs.

In the case of an asset like real estate or a family business, there's an opportunity to leverage the asset's cash flows. Strong or improving cash flows can facilitate transfers with financing internally generated by the business or from the asset itself. To allow increasing cash flow to fund annuity payments more effectively, one could extend the term of the GRAT and take advantage of the ability to step up the annuity payment by 20% each year. A 10-year GRAT structured in this fashion and funded with a \$3.5 million illiquid asset (after a 30% discount) would require an initial annuity payment of only approximately \$187,400, compared with an initial \$789,800 annuity payment if the GRAT term were five years and no discount applied.\*

\* This assumes a 7520 rate of 5.0%. Of course, the longer term of the GRAT increases the risk that the grantor might die during the GRAT term, resulting in the inclusion of all or a portion of the GRAT assets in the grantor's estate for estate tax purposes.

† Some planners even structure the note so that the interest is capitalized each year, and the trust makes no payouts until the note term expires. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

### **A Non-GRAT Alternative: Installment Sales to IDGTs**

However, one of the problems of using GRATs to transfer an illiquid asset is that every year the GRAT must distribute property back to the grantor. Even if it is a long-term GRAT and the trust is created with a 20% increasing annuity (the combination of which will make the early annuities very small), eventually the annuity distributions will probably be large enough that they will have to be paid out with something other than cash or liquid assets. In that event, either fractional interests in the illiquid asset will need to be distributed (requiring more frequent valuations) or the illiquid asset will need to be sold.

An installment sale to an IDGT may provide greater flexibility. For example, the note can be drawn up so that the trust is required to pay interest only during the life of the note, then make a balloon payment of the principal of the note at the end of the note's term.<sup>†</sup> For an asset that generates a low amount of income, paying out interest only can be a more attractive feature than the payout streams associated with GRATs. In addition, the note can be written so that it can be paid down early with no penalty or be refinanced if interest rates have declined.

### **Ready to Roll: Leveraging Liquid Wealth to Transfer Illiquid Assets**

A particularly effective strategy can be to use liquid wealth to transfer illiquid holdings. With liquid wealth to draw on, a grantor could use a rolling GRAT strategy to transfer marketable securities to an IDGT. The IDGT can take the liquid assets, and without triggering capital gains taxes, use them to purchase illiquid assets from the grantor, taking advantage of any valuation discounts. Then the grantor can start the process all over again, funding further rolling GRATs with the liquid assets received. This strategy can provide an elegant, flexible, and effective means of transferring illiquid assets. ■

Other donors may choose to make a gift for the sole benefit of charity. For them, a private foundation or a donor-advised fund may make the most sense. These vehicles are free (or virtually free) of income taxes and provide the donor with an immediate income tax deduction up to the full value of the gift, even though the assets can be distributed to charity over a very long period of time.<sup>38</sup>

A private foundation also offers nonfinancial benefits to a donor who wishes to establish a multi-generational charitable legacy. First, a private foundation can theoretically exist in perpetuity. Accordingly, it allows a donor to create a platform for his family to make charitable gifts for generations. The foundation may remind younger-generation family members of their good fortune, heritage, and responsibility to share with others. It also can provide the senior generation with a way to expose their descendants to a variety of important causes that the senior generation cherish, and provide those descendants with experience of the challenges of running an organization. (For more on foundations, see our earlier publication *Looking Beyond Perpetuity: Customizing a Private Foundation*.)

Families interested in establishing a private foundation must consider how to integrate it into their overall multigenerational wealth plan. One important question is whether the senior generation should fund the foundation during their lifetimes or delay funding until their deaths. And if they choose to fund it while alive, how much can they give to the foundation without derailing their plans to move money to their children or grandchildren? In addition to the nonfinancial benefits a foundation can provide, donors should weigh the following:

- **Value of tax-deferred growth:** A foundation funded during life increases the total wealth to charity because the assets grow virtually tax-free. The size of the advantage depends on factors such as the length of time until the donor's death and the tax efficiency, return, and cost basis of the assets when they are contributed to the foundation.

<sup>38</sup> Various limitations apply to the size of the personal income tax deduction a donor can use to offset income for each of these strategies. Bernstein does not provide tax, legal, or accounting advice; prospective donors considering charitable giving should consult professionals in these fields.

- **Value of the income tax deduction:** A donor who funds a foundation during his life gets an income tax deduction for the gift. A foundation funded at death provides no income tax deduction. The portion of the deduction that can be used during life and the tax rate on the income it offsets are both important.
- **Potential impact on other wealth transfer objectives:** Contributions to a foundation are irrevocable. Consequently, the donor is precluded from using those funds for other wealth transfer strategies like rolling GRATs or an installment sale to an IDGT. And since much of the wealth used for those strategies comes back to the donor, he might still give to charity annually during his lifetime and use some of his remaining assets to fund a foundation at his death. Accordingly, there is a potential opportunity cost to funding a foundation during life.

To judge the pros and cons of prefunding a foundation, let's look at two alternatives:

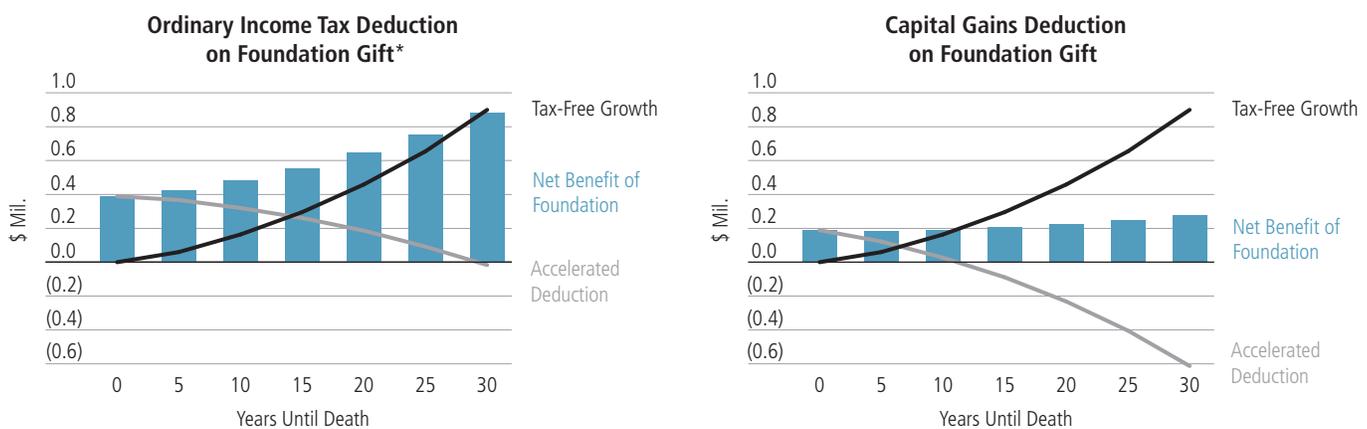
- A donor gives \$1 million to a foundation during his lifetime, and it pays out 5% of those assets each year to charity; or
- The donor retains those assets, gives 5% of them each year to charity (as he would if he'd established a foundation), and leaves the balance to a foundation at his death.

In *Display 36* we analyze the merits of making a lifetime gift to the foundation. On the left-hand side, our analysis assumes that the donor is eligible for a deduction on the full amount of the contribution (\$1 million), and that this amount can be used to offset his ordinary income. The gray line estimates the value of accelerating the income tax deduction by prefunding the foundation. The advantage is very large if the donor dies early: In the extreme case, where his death comes soon after the contribution, he gets about \$400,000 in tax savings from the upfront gift to the foundation—far more than if he'd chosen to make annual gifts to charity during that period. The reason is that a donor who dies early is unable to make enough gifts to realize a large income tax deduction. But the longer the donor lives, the more the advantage of accelerating the deduction diminishes, and eventually turns negative. That's because the deduction from the gift to the foundation, in this example, is limited to \$1 million, while a donor's annual giving over a long life span can amount to *more* than \$1 million of gifts.

Offsetting this declining benefit, however, is the massive additional buildup in wealth for charity attributable to the foundation's tax-free growth, illustrated by the black line. This benefit moves in the opposite direction of the value of the deductions: It starts out small and increases as the benefit

Display 36

### Now or later? The value of prefunding a foundation



\* We assume an ordinary income tax deduction on all lifetime annual gifts made directly to charity.

All accounts are invested in a mix of 80% globally diversified equities and 20% bonds.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See *Notes on Wealth Forecasting System*, pages 48–49, for further details.

Source: AllianceBernstein

of higher tax-free growth compounds over time. All in all, prefunding the foundation yields significant value for all parties. As the bars indicate, the net benefit in the median case is about \$400,000 at the start, and about \$900,000 over 30 years on an inflation-adjusted basis.

On the right of *Display 36* we conduct the same analysis assuming that the donor is still eligible for the deduction. In this case, however, it isn't ordinary income that he's looking to offset but rather a substantial capital gains tax from, say, the recent sale of a family business. Here the benefit of tax-free growth to the foundation is the same as before (the black line), but the benefit of the income tax deduction (the gray line) is smaller. In fact, that "benefit" turns negative much more quickly: That's because there is greater potential reduction in taxes by offsetting ordinary income in future years than realizing lower capital gains taxes now (eliminating a *capital gains tax* at about 20% will likely be less valuable than offsetting an ordinary *income tax* rate in the 40% range, even if the deduction is delayed). As a result, the overall benefit of prefunding a foundation is far lower at the start—about \$200,000—and increases only slightly over time.

It's important to understand the precise range of tax and other benefits that prefunding a foundation may offer. If they're significant and the donor has the excess capital to fund it, it may be a path worth taking. However, if the income tax savings is not very large, the donor might be better off using some of those funds to further leverage the family's wealth transfer strategies and reduce their estate tax burden. The question comes down to this: Should the senior generation fully leverage wealth transfer strategies to further reduce the estate tax, or should they give greater priority to a charitable giving vehicle to maximize their potential income tax savings?

In the end, a successful family foundation may help realize the highest objective of wealth transfer, wherein the value communicated to the charitable cause is coincident with the family's values themselves. It may ripen into the true meaning of a legacy, whereby "the family changed its persons but not its manners, and they continued a blessing to the world from generation to generation."<sup>39</sup> ■

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<sup>39</sup> Sarah Fielding, *The History of the Countess of Dellwyn, 1759*

## IMPLEMENTING, MONITORING, AND ADJUSTING THE PLAN

*Over a three-year period, I gave away half of what I had. To be honest, my hands shook as I signed it away.*

Ted Turner

### The Costs of Control

Despite knowing that forging ahead with wealth transfer is prudent, the senior generation may be reluctant to pull the trigger. They may be nervous about their health or the uncertainties of the capital markets, they may fear that their spending needs will increase in the future, they may question whether the estate tax will be repealed, or they may be concerned about the deleterious effects that wealth transfer could have on their children or grandchildren.

While the senior generation may value the comfort of retaining complete control of their funds, retaining such control for too long is likely to carry a significant financial cost. That cost—in the form of higher transfer taxes—will vary depending on a number of factors specific to each family, such as the senior generation’s ages and longevity, the amount of excess capital, and the wealth transfer strategies they plan to use to reduce their excess capital. *Display 37* provides a rough *qualitative* guide to some of the drawbacks of delaying wealth transfer.

We can also provide some *quantitative* insight into the potential cost of delaying wealth transfer. In *Display 38*, we project the wealth of a 60-year-old couple with significant excess capital. They have \$50 million, spend \$500,000 a year, and are considering making gifts to IDGTs for their four children and six grandchildren and committing \$20 million (or 40% of their total wealth) to a rolling GRAT strategy. Should they implement this plan, they’re likely to reduce their estates to their core capital somewhere around their joint life expectancy—a pace that they feel comfortable with. But if they wait five years before implementing this plan, they’ll give up the benefit of those annual exclusion gifts, the benefit of the gift tax exclusion amounts growing outside their estates, and the buildup from the rolling GRAT strategy, which gains steam as time goes on. The result is a much larger combined estate, resulting in \$5 million in additional estate tax in the median case. And the longer they wait, the more that cost grows; it swells to more than \$20 million if they wait until they turn 75 before they begin.

Display 37

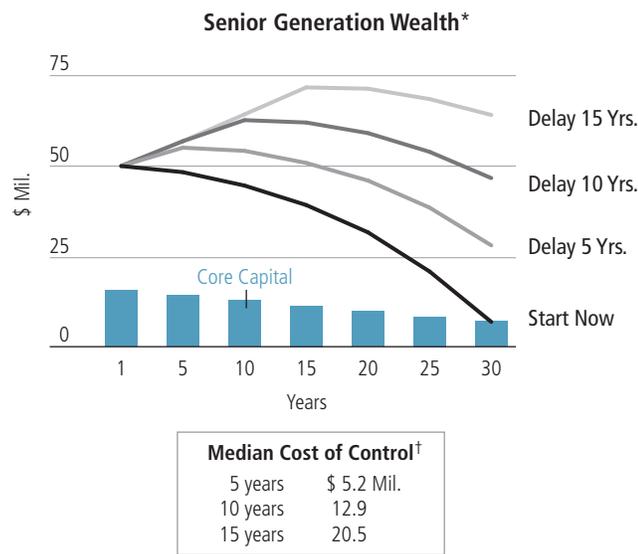
### The drawbacks of delay: Each strategy has its downsides

Transfer Strategy	Potential Cost of Retaining Control
Annual Exclusion Gifts	Gifts are “use it or lose it,” so the cost is the estate tax on the forgone gifts and all the future unspent income and appreciation on the forgone gifts.
Gift Tax Exclusion	The \$1 million gift tax exclusion can be used at any time, but delaying the gift wastes the opportunity to leverage it. The sooner it is used, the sooner the transferred assets can begin to grow outside of the grantor’s estate.
GRATs	The longer the donor delays a rolling GRAT strategy, the more he’ll need to commit to the strategy. Too long a delay may result in significant costs, since the strategy may no longer have the time to reduce the estate sufficiently.
Insurance	Delaying until the senior generation are older might result in higher premium costs; but more certain, and more damaging, is that an unexpected death (before a policy is secured) results in losing the entire death benefit.
Installment Sale to IDGT	The longer the donor delays a sale, the more he’ll need to commit to the strategy. And because the sale requires a minimum “seed” gift to the IDGT, it may be impossible to scale up the sale sufficiently without the payment of gift tax.
Foundation	Each year that the funding is delayed is a lost year of virtually tax-free growth.

Source: AllianceBernstein

Display 38

**Delaying could result in higher estate taxes...**



\* Typical markets; after spending, taxes, and inflation

† Mortality-adjusted; assumes 40% of capital committed to GRATs in each case, that spouses die in same year, that each has a remaining estate tax exclusion of \$1 million, and that estates are subject to tax at a 45% rate.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

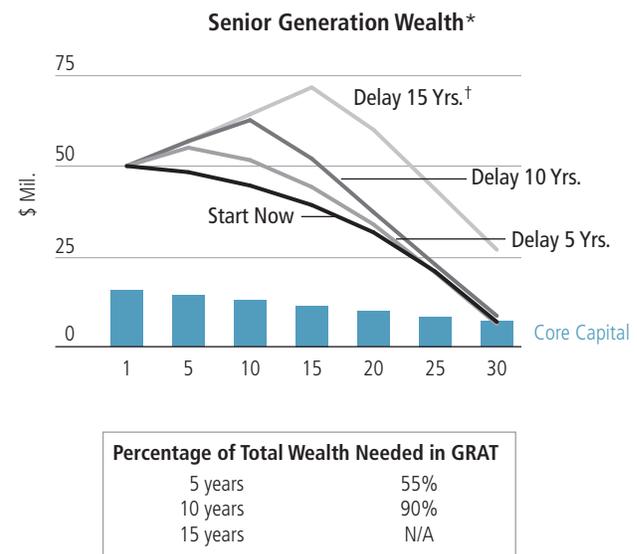
Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

Provided they don't die prematurely, they may be able to catch up with the trajectory of the original plan—but only if they're much more aggressive. For example, if they wait five years, they can get back on their transfer timetable if they increase the amount committed to GRATs from 40% to 55% of their total wealth at that time (*Display 39*). With a 10-year delay, however, they'll need to get really aggressive, setting aside 90% of their wealth in GRATs. And if they wait much longer than that, it's unlikely that they'll have the time to reduce their estates to their core capital no matter what they do.

As this analysis indicates, the cost of the senior generation's retaining control can mount to the point that it significantly erodes the family's wealth. This awareness should spur the senior generation to begin careful planning and take action. And if done properly, they can build enough flexibility into the plan so that any loss of control from the transfer of the funds out of their estates becomes a manageable concern.

Display 39

**...or require a far greater commitment to GRATs to catch up**



\* Typical markets; after spending, taxes, and inflation

† The display assumes 90% of assets contributed to GRATs at that time (Year 15). Based on Bernstein estimates of the range of returns for the applicable capital markets over the duration of the analysis. Data do not represent past performance and are not a promise of actual future results or a range of results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

**Revisiting and Adjusting the Plan**

In fact, a well-crafted wealth transfer plan leaves ample room for the senior generation to make adjustments. We believe it's crucial for a family to have a process for revisiting and changing the plan, because change may become necessary. For example, the funding amounts we've been discussing are based on a very conservative determination of excess capital and anticipate the unlikely possibility of extremely bleak markets.

If those poor markets fail to materialize (which, by definition, is highly likely), the senior generation will have the capacity to transfer even more wealth. In fact, it may turn out that the markets are so superior that they meet any specific wealth transfer goals far earlier than they expect. Of course, if their returns are so strong that they meet those goals quickly, it's likely that their core capital has performed well, too. In that case, they'll find themselves with even more excess capital. Either way, revisiting the plan regularly is critical to its success.

**Why it's important to monitor and adjust the plan over time**

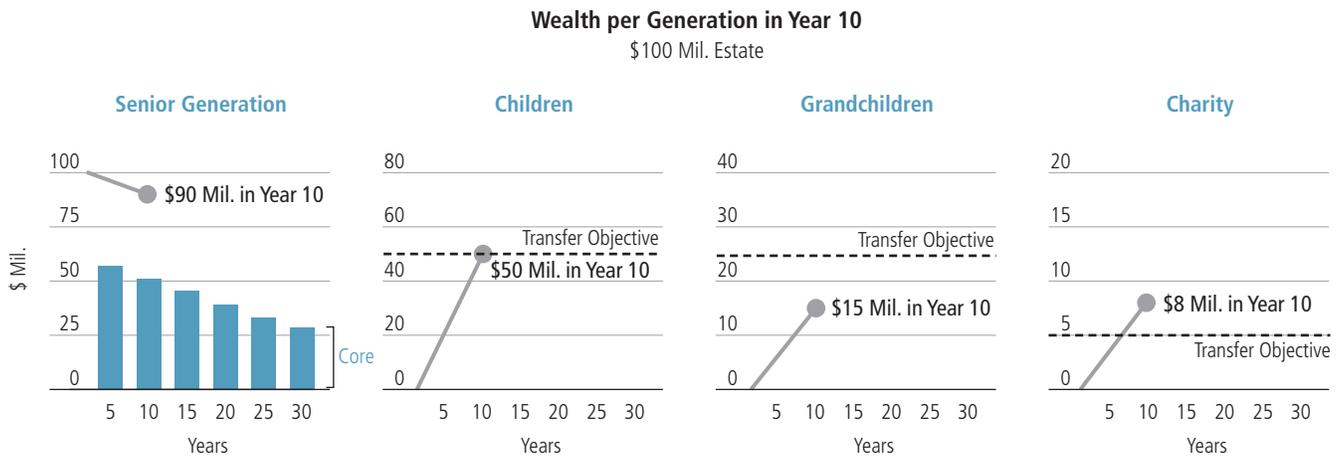
	Plan		Reality		
	Wealth (Start of Plan)	Goal	Wealth (Year 10)	Tracking	Adjustment
Senior Generation's Assets (Personal, GRATs)	\$100 Mil.	\$60 Mil. (in 10 yrs.)	\$90 Mil.	Behind Schedule	Capacity to accelerate transfers Focus on dynasty trust/foundation
Children's Assets (Personal, Grantor Trusts)	\$5 Mil.	\$50 Mil. (in 15 yrs.)	\$50 Mil.	Ahead of Schedule	Increase target but reduce commitment to GRATs from \$50 Mil. to \$25 Mil.
Grandchildren's Assets (Grantor, GST Trusts)	\$1 Mil.	\$25 Mil. (in 25 yrs.)	\$15 Mil.	Ahead of Schedule	Add \$20 Mil. installment sale to dynasty trust (focus on great-grandchildren and beyond)
Foundation's Assets	\$5 Mil.	\$5 Mil. (in perpetuity)	\$8 Mil.	On Track	Add \$20 Mil. in contributions over time

Source: AllianceBernstein

Consider a hypothetical plan for a family where the senior generation have \$100 million. The plan is designed conservatively to ensure that the senior generation always have enough to support their spending needs, that the children have about \$50 million available to them in 15 years, and that the grandchildren have about \$25 million available to them in 25 years. Charity is also an important priority, but the plan is to wait until the senior generation's deaths to fully fund their foundation. This allows them to put more assets to work to transfer wealth to their descendants (see Display 40, left).

Display 40, right, and Display 41 describe the family's actual experience 10 years into the plan. The senior generation still have substantial excess capital, the goal for the children has been met ahead of schedule, the goal for the grandchildren is tracking a bit ahead of schedule, and the foundation has more than preserved its purchasing power, even after making substantial distributions to charity. With this in mind, a change in the structure of the plan is in order. After a series of new projections, the family may make the following decisions:

**When markets outpace the plan**



Source: AllianceBernstein

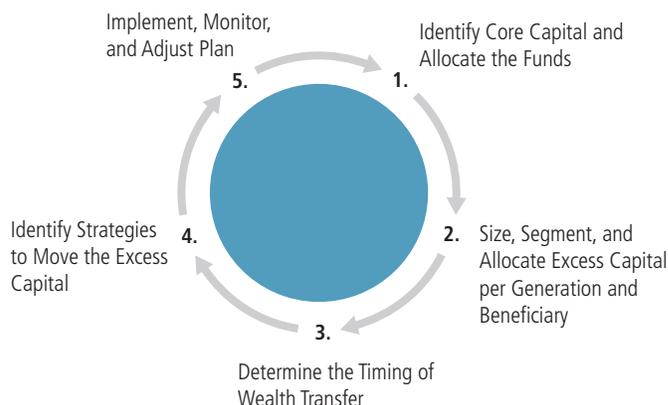
1. They can accelerate the pace of wealth transfer to reduce the potential estate tax burden.
2. They can continue to move money to the children (adding to their original wealth transfer goals), but will do so at a slower pace.
3. They will accelerate the pace of wealth transfer to the grandchildren (and, perhaps, beyond) with an installment sale to the GST-exempt IDGT. Specifically, they realize that they may want to provide for great-grandchildren or even more remote descendants.
4. They can accelerate the pace of their charitable giving by making additional gifts to the foundation now, instead of waiting until they die.

The point is, implementing a wealth transfer plan should not constitute a point of no return. A plan *must* be built with flexibility and revisited at regular intervals as the strategies evolve, the family's circumstances change, and the capital markets inevitably fluctuate.

And as the senior generation take stock of the family's changing wealth picture and review their goals, which may have evolved as well, the whole process should begin again. The senior generation must review their current and projected core capital needs. They can then redetermine their excess capital, assess the size and allocation of the individual buckets of assets for each generation and family member, decide whether to accelerate or decelerate the pace of wealth transfer, and determine whether the strategies they chose remain the best suited to achieve their goals. For that reason, true multigenerational planning must be understood as a regularly recurring, cyclical process (*Display 42*). ■

Display 42

### The cycle of multigenerational wealth management



Source: AllianceBernstein

## APPENDIX

### 1. Core Capital Amounts for Couples Calculated at Different Asset Allocations

#### 0%/100% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.3%	2.5%	2.8%	3.1%	3.5%	4.1%	4.7%	5.5%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$10.9	\$10.0	\$8.9	\$8.1	\$7.1	\$6.1	\$5.3	\$4.5
\$500,000	21.7	20.0	17.9	16.1	14.3	12.2	10.6	9.1
\$750,000	32.6	30.0	26.8	24.2	21.4	18.3	16.0	13.6
\$1,000,000	43.5	40.0	35.7	32.3	28.6	24.4	21.3	18.2
\$1,500,000	65.2	60.0	53.6	48.4	42.9	36.6	31.9	27.3

#### 60%/40% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.8%	3.0%	3.2%	3.5%	3.9%	4.4%	5.1%	6.0%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$8.9	\$8.3	\$7.8	\$7.1	\$6.4	\$5.7	\$4.9	\$4.2
\$500,000	17.9	16.7	15.6	14.3	12.8	11.4	9.8	8.3
\$750,000	26.8	25.0	23.4	21.4	19.2	17.0	14.7	12.5
\$1,000,000	35.7	33.3	31.3	28.6	25.6	22.7	19.6	16.7
\$1,500,000	53.6	50.0	46.9	42.9	38.5	34.1	29.4	25.0

#### 20%/80% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.6%	2.8%	3.1%	3.4%	3.8%	4.4%	5.1%	5.9%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$9.6	\$8.9	\$8.1	\$7.4	\$6.6	\$5.7	\$4.9	\$4.2
\$500,000	19.2	17.9	16.1	14.7	13.2	11.4	9.8	8.5
\$750,000	28.8	26.8	24.2	22.1	19.7	17.0	14.7	12.7
\$1,000,000	38.5	35.7	32.3	29.4	26.3	22.7	19.6	16.9
\$1,500,000	57.7	53.6	48.4	44.1	39.5	34.1	29.4	25.4

#### 80%/20% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.7%	2.9%	3.1%	3.4%	3.7%	4.2%	4.9%	5.7%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$9.3	\$8.6	\$8.1	\$7.4	\$6.8	\$6.0	\$5.1	\$4.4
\$500,000	18.5	17.2	16.1	14.7	13.5	11.9	10.2	8.8
\$750,000	27.8	25.9	24.2	22.1	20.3	17.9	15.3	13.2
\$1,000,000	37.0	34.5	32.3	29.4	27.0	23.8	20.4	17.5
\$1,500,000	55.6	51.7	48.4	44.1	40.5	35.7	30.6	26.3

#### 40%/60% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.8%	3.0%	3.2%	3.5%	4.0%	4.5%	5.2%	6.0%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$8.9	\$8.3	\$7.8	\$7.1	\$6.3	\$5.6	\$4.8	\$4.2
\$500,000	17.9	16.7	15.6	14.3	12.5	11.1	9.6	8.3
\$750,000	26.8	25.0	23.4	21.4	18.8	16.7	14.4	12.5
\$1,000,000	35.7	33.3	31.3	28.6	25.0	22.2	19.2	16.7
\$1,500,000	53.6	50.0	46.9	42.9	37.5	33.3	28.8	25.0

#### 100%/0% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.5%	2.7%	2.8%	3.1%	3.4%	3.9%	4.6%	5.4%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$10.0	\$9.3	\$8.9	\$8.1	\$7.4	\$6.4	\$5.4	\$4.6
\$500,000	20.0	18.5	17.9	16.1	14.7	12.8	10.9	9.3
\$750,000	30.0	27.8	26.8	24.2	22.1	19.2	16.3	13.9
\$1,000,000	40.0	37.0	35.7	32.3	29.4	25.6	21.7	18.5
\$1,500,000	60.0	55.6	53.6	48.4	44.1	38.5	32.6	27.8

### 2. Core Capital Amounts for Single Individuals (Male and Female) Calculated at 60/40 Stock/Bond Allocations

#### Male 60%/40% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	3.0%	3.3%	3.5%	3.9%	4.4%	5.0%	5.7%	6.7%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$8.3	\$7.6	\$7.1	\$6.4	\$5.7	\$5.0	\$4.4	\$3.7
\$500,000	16.7	15.2	14.3	12.8	11.4	10.0	8.8	7.5
\$750,000	25.0	22.7	21.4	19.2	17.0	15.0	13.2	11.2
\$1,000,000	33.3	30.3	28.6	25.6	22.7	20.0	17.5	14.9
\$1,500,000	50.0	45.5	42.9	38.5	34.1	30.0	26.3	22.4

#### Female 60%/40% Stocks/Bonds

Age	50	55	60	65	70	75	80	85
Spending Rate*	2.9%	3.1%	3.4%	3.7%	4.2%	4.8%	5.5%	6.6%
Annual Budget	Core Portfolio in \$ Mil.							
\$250,000	\$8.6	\$8.1	\$7.4	\$6.8	\$6.0	\$5.2	\$4.5	\$3.8
\$500,000	17.2	16.1	14.7	13.5	11.9	10.4	9.1	7.6
\$750,000	25.9	24.2	22.1	20.3	17.9	15.6	13.6	11.4
\$1,000,000	34.5	32.3	29.4	27.0	23.8	20.8	18.2	15.2
\$1,500,000	51.7	48.4	44.1	40.5	35.7	31.3	27.3	22.7

\*Spending is grown with inflation; spending rates assume maintaining spending with a 95% level of confidence.

Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 48-49, for further details.

Source: Society of Actuaries RP-2000 mortality tables and AllianceBernstein

### 3. Amount Transferred by Annual Exclusion Gift per Donee (in \$ Thousands)\*†

Real		5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.	30 Yrs.
Held in Grantor Trust	10% Confidence	\$85	\$233	\$452	\$790	\$1,265	\$1,953
	50% Confidence	64	150	266	421	628	906
	90% Confidence	49	100	162	236	326	437
Held in Taxable Trust	10% Confidence	\$83	\$212	\$385	\$625	\$930	\$1,323
	50% Confidence	63	140	234	349	493	663
	90% Confidence	48	93	145	202	266	342
Nominal		5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.	30 Yrs.
Held in Grantor Trust	10% Confidence	\$96	\$292	\$653	\$1,303	\$2,400	\$4,242
	50% Confidence	73	193	389	691	1,163	1,878
	90% Confidence	57	132	240	387	603	901
Held in Taxable Trust	10% Confidence	\$92	\$265	\$554	\$1,034	\$1,763	\$2,878
	50% Confidence	71	179	341	575	908	1,382
	90% Confidence	55	124	215	333	496	704

### 4. Amount Transferred by \$1 Million Gift Tax Exclusion (in \$ Thousands)\*

Real		5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.	30 Yrs.
Held in Grantor Trust	10% Confidence	\$2,204	\$3,452	\$4,910	\$6,883	\$9,534	\$13,214
	50% Confidence	1,322	1,744	2,300	3,043	4,010	5,312
	90% Confidence	789	887	1,099	1,390	1,748	2,192
Held in Taxable Trust	10% Confidence	\$2,051	\$2,919	\$3,773	\$4,823	\$6,121	\$7,756
	50% Confidence	1,254	1,512	1,821	2,192	2,635	3,181
	90% Confidence	752	772	871	1,001	1,146	1,319
Nominal		5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.	30 Yrs.
Held in Grantor Trust	10% Confidence	\$2,443	\$4,226	\$6,687	\$10,598	\$16,467	\$25,768
	50% Confidence	1,498	2,234	3,323	4,975	7,399	11,089
	90% Confidence	924	1,216	1,738	2,460	3,570	5,075
Held in Taxable Trust	10% Confidence	\$2,272	\$3,567	\$5,133	\$7,397	\$10,489	\$14,835
	50% Confidence	1,419	1,936	2,632	3,578	4,856	6,620
	90% Confidence	880	1,061	1,385	1,780	2,368	3,116

### 5. Amount Transferred per \$1 Million Contribution to Rolling GRATs (in \$ Mil.)\*

Real		5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.	30 Yrs.
Remainders Paid to Grantor Trust	10% Confidence	\$0.98	\$2.21	\$3.68	\$5.70	\$8.34	\$12.09
	50% Confidence	0.30	0.78	1.40	2.19	3.22	4.55
	90% Confidence	0.02	0.21	0.48	0.81	1.22	1.72
Remainders Paid to Taxable Trust	10% Confidence	\$0.95	\$2.04	\$3.20	\$4.67	\$6.41	\$8.72
	50% Confidence	0.29	0.73	1.24	1.84	2.53	3.36
	90% Confidence	0.02	0.20	0.43	0.68	0.96	1.27
Nominal		5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.	30 Yrs.
Remainders Paid to Grantor Trust	10% Confidence	\$1.09	\$2.71	\$5.01	\$8.73	\$14.36	\$23.51
	50% Confidence	0.34	1.01	2.02	3.58	5.91	9.52
	90% Confidence	0.03	0.29	0.77	1.46	2.51	3.98
Remainders Paid to Taxable Trust	10% Confidence	\$1.06	\$2.48	\$4.34	\$7.12	\$11.03	\$16.75
	50% Confidence	0.33	0.94	1.79	3.01	4.65	7.03
	90% Confidence	0.03	0.27	0.68	1.23	1.97	2.98

\* All assets are allocated 100% to globally diversified equities.

† Starts at \$12,000, grown with inflation in accordance with IRC § 2503(b)(2)

Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of actual future results. See Notes on Wealth Forecasting System, pages 48–49, for further details.

## Wealth Transfer Techniques

Technique	Purpose	Description
"Crummey" Power	A power in a trust that gives a beneficiary a lapsing right of withdrawal over contributions to the trust to qualify the contributions for the gift tax annual exclusion.	The trust instrument must provide the beneficiaries with powers of withdrawal over contributions to the trust, and the trustee must notify beneficiaries of their withdrawal powers, to qualify gifts for the gift tax annual exclusion.
Dynasty Trust	To transfer assets to multiple generations with the least possible transfer-tax cost, typically by combining gift or estate tax exclusion with GST-tax exemption.	Typically, the trust is designed to last for multiple generations and provide for discretionary distributions to family members.
Grantor Retained Annuity Trust (GRAT)	To transfer to beneficiaries a portion of the future return of an asset.	The grantor contributes assets to the GRAT. The grantor receives a fixed-dollar annuity from the GRAT for a number of years (the "annuity term"). After the end of the annuity term, the remainder typically passes to children or trusts for their benefit.
Installment Sale to Intentionally Defective Grantor Trust (IDGT)	To transfer to beneficiaries a portion of the future return of an asset.	Typically, the grantor makes a gift of at least 10% of the overall transfer to the IDGT. The grantor then sells the remainder of the assets to the IDGT in exchange for a promissory note bearing interest at a federally determined rate. The trust is designed to pass assets to the children or other beneficiaries.
Irrevocable Life Insurance Trust (ILIT)	To transfer to beneficiaries insurance-policy death benefits with low/no transfer-tax cost.	The grantor contributes assets to the ILIT, and the trustee purchases an insurance policy on the life/lives of the grantor and/or grantor's spouse. Alternatively, the grantor may transfer an existing policy to the ILIT. The ILIT trustee owns the insurance policy and receives the proceeds upon the insured's death, which may be held in further trust.
Family Limited Partnership (FLP) or Limited Liability Company (LLC) <sup>†</sup>	To consolidate management, investment, and disposition of assets in a single business entity, and transfer economic interests in the assets to younger generations.	One or more family members contribute assets to the FLP. The FLP has two classes of owners: general partners (GPs) and limited partners (LPs). GPs own controlling interests and bear FLP liabilities. LPs do not participate in management of the FLP and do not bear FLP liabilities. Depending on the restrictions in the partnership agreement and the nature of the assets contributed to the FLP, certain discounts may be appropriate in the valuation of LP units.
Private Foundation	To make gifts to charities in a tax-efficient manner. A donor can get an immediate income tax deduction for a gift to a foundation, even though the foundation may make grants to charities over multiple generations.	A private foundation is a tax-exempt organization to which a donor can make deductible gifts. A private foundation typically receives its funding from, and is controlled by, a single individual or family.

\* If the trustee purchases the insurance policy, it is excluded from the grantor's gross estate from the point at which the ILIT was created. If the grantor contributes a preexisting policy to the ILIT, the policy will be excluded from the grantor's gross estate beginning as of the third anniversary of the contribution.

<sup>†</sup> In many states a Limited Liability Company (LLC) is an alternative to an FLP. LLCs and FLPs have slightly different structures, but similar purposes and benefits.

Estate/Gift Tax Considerations	GST Tax Considerations	Income Tax Considerations
Depending on the terms of the trust and the applicable circumstances, all or a portion of the value of the trust assets may be includable in a beneficiary's estate at his death for estate tax purposes.	Gifts to a trust with Crummey powers may or may not be subject to GST tax, depending on the terms of the trust. Allocation of GST-tax exemption may be necessary or appropriate for transfers to the trust.	Income taxation varies, depending on the terms of the trust instrument. A trust with Crummey powers can be designed to be a grantor trust during the grantor's lifetime.
Assets retained in the trust will not be subject to estate tax.	This trust is designed to be exempt from GST tax.	The trust can (but need not) be designed to be a grantor trust during the grantor's lifetime.
The grantor can create a GRAT with no gift tax cost if the present value of the annuities equals the contribution. If the grantor survives the annuity term, any amount remaining in the GRAT passes to the remainder beneficiaries free of gift or estate tax. However, if the grantor dies during the annuity term, part or all of the trust assets are included in the grantor's estate for estate tax purposes, reducing or eliminating the benefit of this vehicle.	Typically, not exempt from GST tax.	The GRAT is a grantor trust.
<p>The initial gift to the IDGT is a taxable gift that requires use of the grantor's gift tax exclusion, or, if none, payment of gift tax. The sale will not result in a taxable gift if the value of the promissory note equals the value of the assets sold and if the promissory note bears an interest rate sufficient to avoid an imputed gift.</p> <p>Generally, the gift/sale assets are excluded from the grantor's estate. If the grantor dies during the term of the note, the outstanding note balance is included in the grantor's estate.</p> <p>Appreciation of trust assets exceeding the interest rate on the note passes to the remainder beneficiaries free of gift or estate tax.</p>	This trust can be designed to be exempt from GST tax.	<p>The IDGT is a grantor trust.</p> <p>Initial sale and interest payments to grantor are ignored for income tax purposes.</p> <p>If the grantor dies during the term of the note, the income tax consequences are uncertain, and capital gains tax may be due on the sale as of the grantor's death.</p>
<p>Typically, ILITs are designed to qualify annual contributions for the gift tax annual exclusion. A contribution to the ILIT exceeding the annual exclusion may result in a taxable gift that requires use of the grantor's gift tax exclusion, or, if none, payment of gift tax.</p> <p>The insurance policy is excluded from the grantor's gross estate.*</p>	This trust can be designed to be exempt from GST tax.	Typically, the ILIT is a grantor trust during the grantor's lifetime and becomes a non-grantor trust upon the grantor's death.
Any discounts properly reducing the value of LP units reduce the gift or estate tax exclusion used, or gift or estate tax paid, in transferring those units.	Any discounts properly reducing the value of LP units reduce the GST exemption used, or GST tax paid, in transferring those units.	FLP partners are taxed on their respective pro rata shares of income. Dispositions of partnership interests and the funding or dissolution of the FLP may trigger capital gains or other income tax consequences in certain circumstances.
Gifts to a foundation qualify for the estate and gift tax charitable deductions. The assets of the foundation are not includable in the donor's estate for estate tax purposes.	A gift to a foundation is not subject to GST tax.	A private foundation is exempt from income tax. However, it must pay a small excise tax on its "net investment income," which includes taxable bond interest, dividends, and capital gains. The tax is imposed at a rate of 1% to 2%.

## NOTES ON WEALTH FORECASTING SYSTEM

### 1. Purpose and Description of Wealth Forecasting Analysis<sup>SM</sup>

Bernstein's Wealth Forecasting Analysis is designed to assist investors in making long-term investment decisions regarding the allocation of their investments among categories of financial assets. Our planning tool consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his cash-flow stream is likely to be, whether his portfolio can beat inflation long term, and how different asset allocations might impact his long-term security; (3) The Capital Markets Engine: a model that uses our proprietary research and historical data to create a vast range of market returns and that takes into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and, finally (4) A Probability Distribution of Outcomes: 90% of the estimated ranges of returns and asset values the client could expect to experience, based on the assets invested pursuant to the stated asset allocation, are represented within a range established by the 5% and 95% probabilities. We often focus on the 10th, 50th, and 90th percentiles as representative of the upside, median, and downside cases, respectively. However, outcomes outside this range are expected to occur 20% of the time; thus, the range does not establish the boundaries for all outcomes. Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

### 2. Rebalancing

Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected allocation among cash, bonds, stocks, and REITs over the period of the analysis. Where this is not sufficient, an optimization

program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio will be maintained reasonably close to the target allocation. In addition, in later years there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his personal portfolio and entirely of stocks in his retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value.

### 3. Expenses and Spending Plans (Withdrawals)

All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses, which will have capital gains tax implications.

### 4. Modeled Asset Classes

The following assets or indexes were used in this analysis to represent the various model classes:

Asset Class	Modeled as...	Annual Turnover Rate
Cash Equivalents	3-month Treasury bills	100%
Intermediate-Term Diversified Municipal Bonds	AA-rated diversified municipal bonds of 7-year maturity	30
Intermediate-Term Taxable Bonds	Taxable bonds with maturity of 7 years	30
US Value Stocks	S&P/BARRA Value Index	15
US Growth Stocks	S&P/BARRA Growth Index	15
Developed International Stocks	MSCI EAFE Unhedged	15
Emerging Markets Stocks	MSCI Emerging Markets Index	20
Single Stock (Avg. Volatility)	Volatility: 40%; Dividend: 1.5%; Beta: 1.0	0

### 5. Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed under Assumptions (*facing page*). In general, two-thirds

of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.9%. With intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. These ranges are slightly skewed relative to what one might expect because the volatility calculation assumes the returns are log-normally distributed. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment. It should also be noted that volatility varies in different time periods, particularly for inflation and fixed income assets.

## 6. Technical Assumptions

Bernstein's Wealth Forecasting Analysis is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs that summarize the condition of the capital markets as of September 30, 2007. Therefore, the first 12-month period of simulated returns represents the period from September 30, 2007, through September 29, 2008, and not necessarily the calendar year of 2007. A description of these technical assumptions is available on request.

## 7. Tax Implications

Before making any asset allocation decisions, an investor should review with his or her tax advisor the tax liabilities generated by the different investment alternatives presented herein, including any capital gains that would be incurred as a result of liquidating all or part of the investor's portfolio, investments in municipal or taxable bonds, etc.

## 8. Tax Rates\*

Unless otherwise indicated, Bernstein's Wealth Forecasting Analysis has used the following marginal tax rates:

Start Year	End Year	Federal Income Tax Rate	Federal Capital Gains Tax Rate	Qualified Dividend Rate	State Income Tax Rate	State Capital Gains Tax Rate
2008	2010	35.00%	15.00%	15.00%	6.00%	6.00%
2011	2057	39.60	20.00	39.60	6.00	6.00

\*Federal tax rates are blended with applicable state tax rates by including, among other things, federal deductions for state income taxes.

## 9. Assumptions: Capital Markets Statistics

	Median 50-Year Growth Rate	Mean Annual Return	Mean Annual Income	1-Year Volatility	50-Year Annual Equivalent Volatility
Cash Equivalents	3.4%	3.5%	3.5%	0.7%	7.1%
Int.-Term Diversified Munis	4.5	4.7	4.4	4.6	5.6
Int.-Term Taxable Bonds	5.3	5.6	5.2	5.8	7.0
US Value Stocks	8.0	9.9	2.9	18.2	11.8
US Growth Stocks	8.0	10.2	1.6	20.0	13.8
Developed Int'l Stocks	7.8	10.8	2.9	22.2	13.1
Emerging Markets Stocks	6.4	11.4	2.6	27.7	21.3
Inflation	2.4	2.5	NA	1.5	7.0
Single Stock	3.6	10.0	2.0	38.7	32.9
HF-Long/Short-High Volatility-Tax Aware (Current)	11.6	13.4	2.5	18.6	30.1
HF-Market Neutral-Tax Aware (Current)	6.2	6.5	3.5	7.2	20.2

Based on 10,000 simulated trials, each consisting of 50-year periods. Reflects Bernstein's estimates and the capital markets conditions of September 30, 2007. Does not represent any past performance and is not a guarantee of any future specific risk levels or returns, or any specific range of risk levels or returns. For hedge fund asset classes, "Mean Annual Income" represents income and short-term capital gains.

## 10. Mortality

Mortality is modeled using our proprietary simulation model, which creates a range of death ages for a given age and sex. The outcomes of the mortality simulation model are then combined with the outcomes of the Capital Markets Engine on a trial-by-trial basis to produce summarized mortality-adjusted results. Mortality simulations are based on the Society of Actuaries, Retirement Plan Experience Committee Mortality Tables RP-2000.

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Transportation and the Economy
- The Envious Dilemma:  
Concentrated Stock—Hold, Sell, or Hedge?
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- Market Timing:  
If It Feels So Right...How Can It Be So Wrong?
- The Role of Faith in Investing

**Please contact your Bernstein Advisor if you'd like more information on or a copy of any of these publications.**



Bernstein was founded in 1967 to manage investments for individuals and families and is dedicated solely to investment research and management. Today, as a unit of AllianceBernstein L.P., we oversee some \$109 billion\* in private capital. Research is the basis of our ability to prudently manage the assets under our care; it is also the foundation of the full array of investment products, both global and local, that we offer.

### **OUR CLIENT-CENTERED MISSION**

- To have more knowledge and to use knowledge better than any other investment firm in the world
- To use and share knowledge to help our clients achieve investment success and long-term security
- To place our clients' interests first and foremost

### **Research Excellence**

We believe that superior research is the ultimate source of superior investment returns and requires both knowing more and using knowledge better. Knowing more—having an information advantage over other market participants—requires doing deep fundamental and economic research on a truly global scale. Using knowledge better means identifying and exploiting pricing anomalies that can provide incremental return and employing portfolio-construction techniques to manage risk and return efficiently.

With those goals in mind, we've built one of the largest and broadest research footprints in the business: 303 analysts\* operating in 12 countries and covering thousands of securities in capital markets around the world. Our research effort is organized into separate groups dedicated to growth equities, value equities, fixed income, and real estate trusts, reflecting the unique needs of each investment approach.

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We leverage our research with systematic portfolio management. Because our top investment management professionals determine the policies and make the decisions that underlie all our investment strategies, each client, regardless of account size, gets the very best our firm has to offer. These strategies and decisions are then further customized in relation to each account's tax status and the client's goals and circumstances.

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We offer value, growth, and style-blended stock portfolios across the global markets, real estate investment trusts, hedge funds, and taxable and tax-exempt fixed income portfolios—all actively managed.

### **Wealth Management Planning**

Because we recognize that private clients of very substantial means have complex needs, we've created a team of people with expertise in a wide range of disciplines to counsel clients on sophisticated financial planning. Our wealth management professionals have experience in areas such as estate planning, intergenerational wealth transfer, philanthropy, alternative asset classes, liquidity events, and investment strategies for corporate executives. Working together with our clients' other professional advisors and aided by a quantitative state-of-the-art wealth-forecasting tool, we stress-test multiple solutions to complex investment problems to help clients identify the strategies best suited to them financially and emotionally.

### **Client Service and Communications**

We recognize that client needs are varied. Our investment professionals seek to provide clients with the investment approach that is best for them, and they pride themselves on personalized and timely service. Further, our content-rich communications explain the research basis for our portfolio decisions, our analysis of recent market developments, and our market outlook, as well as other research findings. ■

\*As of December 31, 2007

