

# WEALTH TRANSFER STRATEGIES: THE TIMELY AND THE TIMELESS

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At least one silver lining has emerged from the recent dark clouds over financial markets: Low interest rates and depressed asset valuations make it easier to escape gift and estate taxes. But be careful not to rush into long-term plans based on short-term economic trends. Seemingly attractive market opportunities can be misleading, although any opportunity that triggers a review of your estate plan is useful.

WHEN THE FEDERAL RESERVE SLASHED interest rates early this year, a spate of headlines declared the time was right for certain tax-minimization strategies. As the *Wall Street Journal* wrote: “Low interest rates and the slumping market make this the best time in at least five years to use so-called estate-freeze strategies, which can help shield a fortune from estate taxes, say wealth advisors.”<sup>1</sup>

While it is true that low interest rates and a slumping market may facilitate a few such strategies, trying to “time” estate planning according to market conditions is shortsighted. Smart estate planning is timeless: You can shield wealth from gift and estate taxes in any interest rate or market environment. For example, as Bernstein research has shown, a series of “rolling” short-term grantor-retained annuity trusts (GRATs) funded with publicly traded stocks is a simple and effective wealth transfer strategy, regardless of market conditions at its inception.<sup>2</sup>

Nonetheless, given the recent upheaval in the markets and the decline in interest rates, many individuals and their professional advisors are being tempted to establish long-term GRATs in order to “lock in” a low rate. For a fresh perspective on the effect of interest rates and market conditions on wealth transfer, we conducted new research on GRAT strategies. The results were eye-opening:

- > Contrary to common wisdom, locking in a low interest rate on a long-term GRAT is almost certainly not the best choice among GRAT strategies for transferring liquid assets. A series of rolling short-term GRATs will most likely outperform a long-term GRAT *regardless of interest rates*.
- > Further, a rolling GRAT strategy will most likely outperform a long-term GRAT regardless of the stock market environment at the strategy’s inception.

<sup>1</sup> “Market Slump Means Time Is Right for Strategies to Curtail Estate Taxes,” *Wall Street Journal*, April 1, 2008, page D4.

<sup>2</sup> See *Keeping It in the Family: Planning for Efficient Wealth Transfer*, Bernstein, May 2006.

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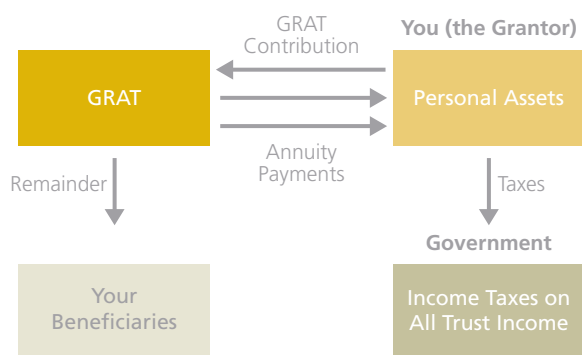
### The Case for Wealth Transfer Today

When interest rates drop, you can expect to hear that “it’s a great time to GRAT,” because a key rate set by the IRS, the so-called Section 7520 rate, is integral to the GRAT structure.

As shown in *Display 1*, a GRAT is a trust that allows you to move a portion of the future return on assets to beneficiaries without paying gift tax or using your gift-tax exemption. You make an irrevocable gift to the GRAT and retain the right to receive an annuity payment from it each year during the trust’s term. Anything left in the GRAT at the end of its term passes to your beneficiaries. If you structure the GRAT so that it is “zeroed-out”—in other words, so that the present value of the annuity payments equals the value of the assets you transfer to the GRAT—then you have made no gift under tax law.

Display 1

#### A simple GRAT structure

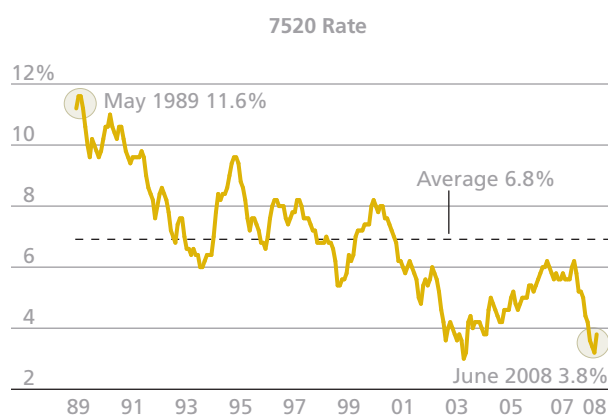


Source: AllianceBernstein

Here’s why the 7520 rate matters: It is the interest rate for the present value calculation. The IRS publishes the 7520 rate monthly. In simple terms, it is set at a modest premium to prevailing intermediate-term interest rates. As *Display 2* shows, the 7520 rate is near its historical low.

Display 2

#### The hurdle rate set by the IRS is near an all-time low



Source: US Treasury Department

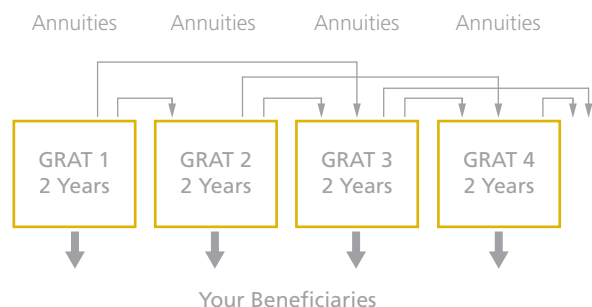
A low 7520 rate sets a lower “hurdle” for a GRAT to succeed in transferring wealth. If the assets in the GRAT grow at a rate in excess of the 7520 rate, all that excess growth (the “remainder” of your GRAT) will transfer to your beneficiaries free of gift tax. This is the allure of locking in a low 7520 rate for a long term—it should be easier to beat—but it may not be the wisest choice. For a more nuanced perspective, let’s take a look at an alternative GRAT strategy—rolling short-term GRATs.

In a rolling GRAT strategy (*Display 3*), you create a short-term GRAT (say, two years) and use each year’s annuity to create a new GRAT. You can keep doing this for as many years as you want, but for the sake of comparison, suppose you continue this process for 10 years. During this time you will have created nine two-year GRATs (the final one expires at the end of year 10).

Previous Bernstein research has shown that a rolling short-term GRAT strategy will most likely outperform a single, long-term GRAT for two main reasons:

Display 3

Rolling GRATs can lock in gains



Source: AllianceBernstein

First, it keeps more of the capital committed to the strategy. In a single long-term GRAT, the capital declines each year, as the annuity payments return assets in the GRAT to you, the grantor. By contrast, the rolling GRAT strategy maintains all of the original capital committed to the strategy in the GRATs.

Second, the shorter, two-year time horizon minimizes the chance that good investment performance in one year will be offset by poor investment performance in another year. Even if the compound return during a 10-year period is poor, there may be good two-year periods along the way that will successfully transfer wealth.

As an example, consider the decade that just ended: 1998 through 2007. This dramatic period saw the rise of the tech stock bubble, the depths of the ensuing bear market, and a strong recovery. From start to finish of this roller-coaster ride, stocks turned in a 5.9% annualized return. Yet, as *Display 4, following page*, shows, a 10-year GRAT funded with \$5 million in 1998 would have failed to transfer any wealth. A series of rolling two-year GRATs, however, would have succeeded in six of the 10 years, transferring \$3.4 million out of your estate free of gift tax. This shows how the rolling GRAT strategy capitalizes on the volatility of the stock market.

<sup>3</sup> See Notes on Wealth Forecasting Analysis at the end.

KEY CONCEPTS

- > The common wisdom that low interest rates recommend creation of a long-term grantor-retained annuity trust (GRAT) may cause individuals and wealth planners to overlook a better GRAT strategy
- > Building on previous Bernstein research, new analysis and a study of historical data show that rolling short-term GRATs are more likely to transfer more wealth, free of gift tax, than a long-term GRAT, regardless of interest rates or market environment
- > “Don’t try to time the market” is good advice in investment management, and our new research indicates it is equally apt for estate planning

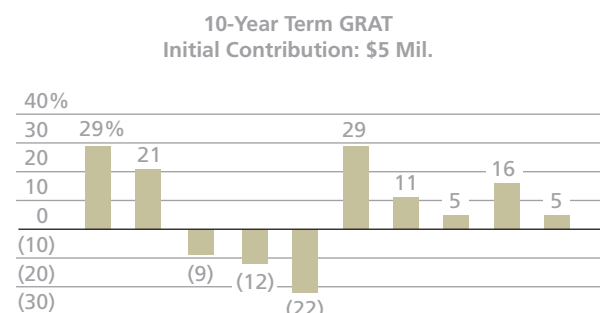
Just How Important Are Low 7520 Rates?

One might argue that in the example above, the 7520 rate was much higher than it is today: In 1998 it was 7.2%; in June of this year it was 3.8%. Shouldn’t such a low rate provide a powerful tailwind to the long-term GRAT structure? Since no one can predict what the markets will do in the future, we approached the question in two ways: 1) by forecasting potential future market returns, using Bernstein’s proprietary Wealth Forecasting System,<sup>3</sup> and 2) by looking at history—which in some periods (the 1940s and early 1950s) had interest rates even lower than today’s.

First, using our Wealth Forecasting System, we modeled 10,000 future market environments to show their effect on two GRAT strategies: a single 10-year term GRAT versus a series of two-year rolling GRATs for 10 years. Next, we looked at the GRATs beginning in low interest rate periods—defined as the lowest quartile of 7520 rates modeled. The rolling GRAT strategy

Display 4

1998–2007: How rolling short-term GRATs capitalized on volatility



Initial Section 7520 Rate:	7.2%
10-Year S&P Compound Return:	5.9%
<b>Remainder:</b>	<b>\$0.0</b>

Year	7520 Rate	S&P Annual Return	S&P Compound Two-Year Forward Return	Wealth Transferred
1998	7.2%	28.6%	24.8%	\$0
1999	5.6	21.0	4.9	\$1.65 Mil.
2000	7.4	(9.1)	(10.5)	\$179,756
2001	6.8	(11.9)	(17.1)	\$0
2002	5.4	(22.1)	0.1	\$0
2003	4.2	28.7	19.4	\$0
2004	4.2	10.9	7.8	\$877,809
2005	4.6	4.9	10.2	\$190,887
2006	5.4	15.8	10.5	\$176,527
2007	NA	5.5	NA	\$322,580
<b>Total Remainder:</b>				<b>\$3.4 Mil.</b>

Term GRATs assume 20% increasing annuities, while rolling GRATs assume constant annuities. See Notes on Wealth Forecasting Analysis, page 34. Source: Standard & Poor's, US Treasury Department, and AllianceBernstein

won handily, succeeding more than 98% of the time, compared with a 10-year term GRAT success rate of only 76%.

As noted above, one reason a rolling GRAT strategy will likely outperform a single long-term GRAT is that it keeps more of the capital committed to the strategy at work. Accordingly, we also tested the benefit of locking in a low interest rate by modeling a 10-year GRAT

structure that uses its first annuity to create a nine-year GRAT, and its next annuity (plus the nine-year GRAT's first annuity) to create an eight-year GRAT, and so on, keeping all the money at work and ending with a two-year GRAT. Yet, as *Display 5* shows, this strategy will likely underperform the simple rolling short-term GRAT strategy—both in terms of success rate and the median amount transferred.

Display 5

Even with low interest rates, rolling short-term GRATs beat other GRAT strategies

	10-Year Term GRAT*	10-Year Term GRAT with Annual Decreasing Term GRATs*	Rolling Short-Term GRATs
Probability of Success	76%	96%	>98%
Median Wealth Transfer	\$3.6 Mil.	\$5.3 Mil.	\$7.4 Mil.

All strategies are funded with \$10 million, beginning in the lowest-quartile interest rate environments. All assets are invested in a globally diversified equity portfolio composed of 35% US value/35% US growth/25% developed international/5% emerging markets stocks. Wealth to beneficiaries is reinvested and adjusted for inflation. See Notes on Wealth Forecasting Analysis, page 34.

\*The 10-year term GRAT in each case uses 20% increasing payouts to keep money at work, as do the nine-year through three-year term GRATs in the decreasing term GRAT strategy. Rolling GRATs have constant annuities. Source: AllianceBernstein

A Historical Analysis Drives the Case Home

While the simulated results were compelling, we were curious to see how the term GRAT and rolling GRAT strategies would have fared historically. We compared the results of the two strategies—rolling short-term versus 10-year term—assuming they had been launched every month from May 1941 through April 1998, for 684 trials in all. We assumed each GRAT began with \$10 million invested in the S&P 500. And, since the 7520 rate has existed only since 1989, we created a proxy for earlier periods based on the IRS methodology. This 57-year span covers a wide range of interest rates and stock market returns, with the 7520 rate averaging 6.7%, but dipping as low as 1.2%.

Display 6

**1941–1998: Rolling short-term GRATs beat long-term GRATs**

	Rolling GRATs	10-Year Term GRATs
Frequency of Success	100%	80%
Median Wealth Transfer	\$11.0 Mil.	\$6.1 Mil.

All strategies are funded with \$10 million and invested in a portfolio representative of the S&P 500. Wealth to beneficiaries is reinvested and adjusted for inflation. See Notes on Wealth Forecasting Analysis, page 34. Term GRATs assume 20% increasing annuities, while rolling GRATs assume constant annuities.  
Source: AllianceBernstein

The results were striking: The rolling short-term GRAT strategy beat the 10-year term GRAT in every period, and succeeded 100% of the time at transferring wealth to the next generation, while the long-term GRAT succeeded only 80% of the time, as *Display 6* shows.

Not only was the rate of success higher, but the amount of wealth transferred was much greater. Even when the 10-year term GRATs succeeded, the rolling GRAT strategy transferred nearly twice as much wealth: a median transfer of \$11.0 million compared with \$6.1 million.

We also compared shorter-term GRATs, because a 10-year term might not fit every individual’s needs. The results were comparable: Running the same historical analysis using four-year term GRATs versus four years of rolling two-year GRATs, the rolling strategy succeeded 98% of the time, compared with 79% for the term GRATs. And out of 684 trials, the four-year GRAT transferred more wealth than the rolling strategy only 18 times, or in just 2.6% of the trials.

**An All-Market Strategy**

What about the stock market environment? One might argue that if the stocks in a GRAT were poised for an upsurge (even though no one can predict future performance), a

Display 7

**1941–1998: Rolling GRATs beat term GRATs in both bull and bear markets**

	S&P 500 Trailing 12-Month Return	10-Year Term GRAT Median Remainder	Rolling Short-Term GRAT Median Remainder
Lowest Quartile	(38.9)% to 2.3%	\$6.6 Mil.	\$11.0 Mil.
Second Quartile	2.5% to 14.4%	\$6.5	\$11.4
Third Quartile	14.4% to 26.1%	\$4.3	\$10.4
Highest Quartile	26.2% to 61.2%	\$5.6	\$10.9

All strategies are funded with \$10 million and invested in a portfolio representative of the S&P 500. Wealth to beneficiaries is reinvested and adjusted for inflation. See Notes on Wealth Forecasting Analysis, page 34. Term GRATs assume 20% increasing annuities, while rolling GRATs assume constant annuities.  
Source: AllianceBernstein

long-term GRAT might outperform rolling short-term GRATs. But as *Display 7* shows, rolling GRATs outperformed term GRATs by wide margins, no matter what the stock market had done in the year prior to the strategies’ inceptions. This reflects the fact that historically, stocks have tended to rise over any 10-year period, with market downturns being relatively short in duration.

In summary, our research provided an overwhelming case against trying to “time” your wealth transfer strategy with GRATs. Regardless of interest rates or the current market environment, a strategy of rolling short-term GRATs funded with publicly traded stocks appears very likely to provide better results than a single, longer-term GRAT.

**When Timing Does Pay Off**

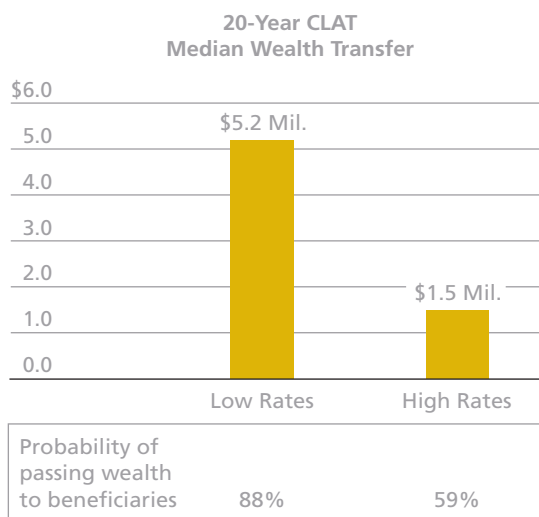
A few wealth transfer strategies will benefit from low interest rates. For example, our research showed that charitable lead annuity trusts (CLATs) should perform better when launched in low interest rate environments. CLATs resemble GRATs, with the main difference being that the annuities go to charity,

rather than back to the donor. As a result, a rolling short-term structure is impossible because each year’s annuity goes to charity and is out of your hands. This favors a longer-term structure, so that the assets have plenty of time to grow. Consequently, CLATs are typically created with long terms—10 to 20 years.

We used our Wealth Forecasting System to model hypothetical 20-year CLATs funded with a \$10 million initial contribution. We compared how CLATs would fare if started in a low interest rate environment (defined as the lowest quartile of interest rate scenarios) versus high interest rates (the top quartile). *Display 8* shows the results: CLATs perform much better with a low 7520 rate.

Display 8

**CLATs benefit from a low hurdle rate**



Low rates are defined as the bottom quartile of potential interest rate scenarios; high rates defined as the top quartile. Wealth to beneficiaries is adjusted for inflation.

CLAT strategies are funded with \$10 million, with assets invested in a diversified portfolio composed of 60% equities (35% US value/ 35% US growth/25% developed international/5% emerging markets stocks), 30% taxable bonds, and 10% REITs. See Notes on Wealth Forecasting Analysis, page 34.

Source: AllianceBernstein

If a CLAT strategy suits your estate planning goals, today’s market conditions are ideal.

However, CLATs are not right for everyone, or every situation. First, success is by no means guaranteed. Even in the low interest rate scenarios, only 88% of the CLATs in our simulation had money left at the end of their term. So if your primary goal is to pass money on to the next generation, better wealth transfer vehicles exist. Further, if your primary goal is giving to charity, there may be better ways to do so.

**It’s Always a Good Time for Estate Planning**

One of the well-worn maxims of investment management is that it doesn’t pay to time the market. This wisdom applies to wealth transfer strategies as well. While a few specialized strategies, such as CLATs, may benefit from low interest rates, it is better to start early with a comprehensive estate plan designed to weather any market environment, rather than waiting for the market to turn your way.

The reasons are simple: First, as our research above shows, a rolling short-term GRAT strategy can effectively transfer wealth regardless of interest rates or market environment. Second, by trying to time the market you run the risk of using up your “time capital,” that is, the amount of time you have to transfer wealth during your lifetime. In other words, for every year you procrastinate, you lose the ability to transfer assets and have them grow outside of your estate, and you increase the risk that upon your death you will leave an overly large estate for the government to tax.

If, however, the current market environment induces you to “use lemons to make lemonade,” today is as good a time as any to consider estate planning. Just be sure to consult your tax advisor and use a thoughtful approach grounded in research, rather than relying on common wisdom. ■

## Notes on Wealth Forecasting Analysis

The Bernstein Wealth Forecasting Analysis<sup>SM</sup> (WFA) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFA consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long-term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model, which uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases. Asset-class projections used in this publication are derived from the following: US value stocks

are represented by the S&P/Barra Value Index, with an assumed 20-year compounding rate of 8.2%, based on simulations with capital market conditions as of December 31, 2007; US growth stocks by the S&P/Barra Growth Index (compounding rate of 8.1%); developed international stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged (compounding rate of 8.0%); emerging markets stocks by the MSCI Emerging Markets Index (compounding rate of 6.6%); taxable bonds by diversified securities with seven-year maturities (compounding rate of 5.4%); real estate investment trusts (REITs) by the NAREIT Index (compounding rate of 5.3%); a single stock with a beta of 1.0, volatility of 30%, and a dividend yield of 0% (compounding rate of 5.3%); and inflation by the Consumer Price Index (compounding rate of 2.5%). 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-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this 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.