► *Greycourt White Paper*

White Paper No. 7 – *Combining Estate Planning with Asset Allocation*

Background

Although estate planning has long played a critical role in preserving wealth for future generations, this area has been dominated by attorneys and trust administrators. Investment professionals, however, can benefit their clients by developing an understanding of how the mechanics of wealth-transfer techniques work. The integration of asset allocation techniques with estate-planning structures allows investment advisors to enhance the after-tax, multigenerational value of clients' overall portfolios.

This presentation examines the importance of integrating asset allocation techniques with several commonly used financial estate-planning vehicles. The first portion of this presentation focuses on describing the mechanics of two specific trust vehicles designed to reduce taxes. The final section considers the important and beneficial effect that funding these trust vehicles with the right kinds of investments can have on maximizing multigenerational wealth transfer.

Discussion

Gifts, Charity, and Taxes

Clients are often confused and even paralyzed by the sheer number of decisions they are asked to make regarding investment strategies, financial planning advice, and tax issues. Nevertheless, when investment advisors peel back the jargon and focus clients on their fundamental attitudes about wealth, the investment decision-making process becomes more straightforward. Stated simply, investors can do only so many things with their wealth. First and foremost, clients can spend it. In this presentation, spending does not mean buying a yacht or a home or jewelry; such spending is simply reinvesting in nonfinancial assets, which is an asset allocation decision. True spending means consumption in other words, buying things a person can eat, smoke, or wear.

For most wealthy individuals, their investment portfolios are likely to be larger than the amount that can be consumed. Such clients possess only three remaining options for their money: they can give it to their children, donate it to charity, or pay it in taxes.

Individuals have differing objectives. Some want to pass as much wealth as they can to their children, and others worry about spoiling them. Some are

charitable; others are selfish. Many clients have not yet decided what they want to achieve with their wealth, so they feel uncertain about irrevocably committing to a plan of personal spending versus wealth transfer versus charitable giving. The only characteristic shared by nearly every client is that no one wants to pay taxes.

Given the near universal aversion to the payment of taxes, the financial and legal communities have developed a series of clever techniques designed to minimize such payments. The two commonly employed methods are the charitable remainder unit trust (CRUT) and the grantor retained annuity trust (GRAT).

Charitable Remainder Unit Trust. A CRUT enables individuals to transfer assets to an irrevocable trust that is structured both to make an annual cash flow distribution back to them during their lifetime and to transfer the remaining assets to charity upon their death.

A client who establishes a CRUT benefits in a number of ways. First, the transfer of assets defers (or eliminates) the capital gains taxes associated with the sale of the low-cost assets. Second, the transfer creates a charitable tax deduction, which can provide a tax shelter for income or capital gains in the main portfolio. Third, the transfer generates an annual cash flow distribution back to the main portfolio. This cash flow establishes annual liquidity, and clients psychologically view the distributions from the CRUT as income. (Of course, clients can sell low-cost assets in their main portfolio and create liquidity for themselves, but most are reluctant to do so.) Finally, at the termination of the CRUT, the residual wealth transfers to charity, which satisfies the client's charitable intent.

Individuals interested purely in charity would not engage in a CRUT transaction but would instead make direct and current charitable gifts. The purpose of a CRUT, however, is to retain some benefit from the value of the assets gifted. Ultimately, either at the end of the CRUT's term or at the end of the grantor's life, the assets remaining in the CRUT pass to charity.

Grantor Retained Annuity Trust. In broad terms, a GRAT has the same general objective as a CRUT: to transfer assets from an individual's portfolio to a trust in a way that minimizes or eliminates taxes.

As with a CRUT, the grantor (the individual funding the GRAT) derives a direct economic benefit from the arrangement because the GRAT pays an annuity back to his or her main portfolio. At the end of the GRAT's term, assets remaining in the trust after satisfying the required annual annuity payments are transferred to the next generation free of the 55 percent gift and estate tax.

Case Study

As an example of the role of the complex considerations involved in using irrevocable trusts, consider a hypothetical client, I.M. Rich, who recently sold his Silicon Valley firm Mystock.com to Fertilizer Company for $100 million in Fertilizer Company common stock. The managers of Fertilizer Company view Mystock.com as an attractive means of diversifying the company's revenue stream and believe that the acquisition offers potential synergies with its existing business. Rich, however, is skeptical about Fertilizer Company's wisdom because it paid him $100 million for his company, which has little to no prospect of generating positive earnings. Instead of holding onto Fertilizer Company shares and hoping for future appreciation, Rich decides to sell. Not surprisingly, Rich is soon barraged by numerous phone calls from insurance agents, estate planners, and other investment professionals seeking to offer their "advice."

Although the sheer variety of investment options confuses Rich, who is unfamiliar with the investment arena, he is resolute about his life's objectives. He wants to maximize the transfer of his wealth to his children subject to gifting $38 million to charity but only at his death. He wants to maintain the lifestyle to which he has become accustomed, which requires $1 million in annual after-tax income. Finally, because he might decide that his children are not deserving or because he might choose to start another company or simply change his priorities, he wants no more than 25 percent of the portfolio to be dedicated to irrevocable transactions. He expects his investment time horizon, or life expectancy, to be 20 years, and he is in the top income-tax bracket.

Rich first wants to know how much his three children would receive if he simply sold his Fertilizer Company shares, paid the required capital gains tax, and reinvested the proceeds in a diversified portfolio. The first step is to assess Rich's tolerance for risk and to develop an appropriate asset allocation plan. **Table 1** shows the assumptions used to design an efficient portfolio suitable for Rich's risk tolerance. In this simple example, Rich is presented with three asset classes that represent alternate levels of risk: low for bonds, moderate for U.S. stocks, and very high for emerging market stocks.

Table 1. Asset Class Assumptions

Asset Class	Pretax Total Return	Capital Appreciation	Yield	Risk
Bonds (tax free)	5.0 %	0.0 %	5.0 %	5.5 %
Bonds (taxable)	7.0	0.0	7.0	5.5
U.S. Stocks	8.5	6.5	2.0	14.0
Emerging market stocks	12.0	11.0	1.0	27.0

After reviewing his tolerance for risk, Rich selects a portfolio composed of 40 percent bonds, 45 percent U.S. equities, and 15 percent emerging market stocks. As shown in **Table 2**, if Rich sold his $100 million in stock, paid the capital gains tax, and reinvested in this diversified portfolio, the portfolio by the end of Year 1 would generate investment income of about $3 million and would appreciate by about $4.5 million. Offsetting these sources of return, Rich would have to pay management fees of about $400,000 and income tax of about $308,000 (because of the dividends generated by the stocks.) Also, because of the active management of U.S. large-cap and emerging market stocks, Rich would incur short-term capital gains taxes of about $52,000 and long-term capital gains taxes of about $150,000. Finally, Rich would pay a whopping $20 million of taxes associated with the liquidation of the zero-cost stock in Fertilizer Company. All told, at the end of Year 1, Rich's main portfolio would be worth $85.6 million (nearly $15 million less than what he started with).

Table 2. After-Tax Annual and Terminal Wealth for Portfolio Using No Financial Planning

	Year 1	Year 2	Year 20
Starting balance	$100,000,000	$85,638,918	$222,602,478
Annual spending	-1,000,000	-1,000,000	-1,000,000
Investment income	3,019,500	2,581,487	5,630,376
Capital gains	4,529,249	3,854,393	9,445,563
Management fees	-398,475	-340,672	-743,025
Income taxes	-308,731	-263,946	-575,683
Short-term gains taxes (active management)	-51,749	-68,157	—
Long-term gains taxes (active management)	-150,876	-211,520	—
Short-term gains taxes (rebalancing)	—	-17,837	—
Long-term gains taxes (rebalancing)	-20,000,000	-141,127	—
Estate tax	—	—	-106,176,423
Charitable gift	—	—	-38,000,000
Ending Balance	$85,638,918	$90,049,376	$91,183,286

From Rich's perspective, the most important consideration is not the value of the portfolio after only one year but rather the expected value of the portfolio in 20 years the end of his expected lifespan. Of particular importance is the amount that would remain for his children after the desired $38 million distribution to charity and the required payment of the 55 percent estate tax. By the end of his life, on an after-tax, preliquidated basis, Rich's portfolio would have grown to almost $223 million. Upon Rich's death, the executor of his estate would transfer

$38 million to charity in order to satisfy Rich's stated charitable objectives. The remaining assets in the portfolio would be taxed at 55 percent, resulting in an estate tax bill of about $106 million. After all transfers, taxes, and fees are paid, the children would receive $91.18 million. This amount represents the projected value of the portfolio absent any type of estate planning. Any other strategies must transfer greater wealth to Rich's children than this amount in order for them to be considered.

To understand how devastating fees and taxes can be, consider the fact that 56 percent of Rich's portfolio would be consumed by the following costs: taxes from rebalancing the portfolio, 7 percent; management fees, 4 percent; income tax, 3 percent; estate tax 37 percent; and manager-generated taxes, 5 percent. Consequently, after Rich's gift to charity (13 percent of his terminal wealth), the transfer of remaining wealth to the children would represent only 31 percent of the ending value of his portfolio.

The Value of Financial Planning. Rich's attorney has suggested that he consider funding a $25 million CRUT in order to defer some of the up-front tax payments associated with the liquidation of Fertilizer Company Stock. In order to isolate the value of the CRUT transaction, assume that the asset allocation within the CRUT is identical to the asset allocation within Rich's main portfolio (i.e., 40 percent bonds, 45 percent U.S. stock, and 15 percent emerging market stock.) The CRUT offers three advantages. First, transferring $25 million to the CRUT would generate a 10 percent, or $2.5 million, charitable deduction that could be used to offset income or capital gains in Rich's main portfolio. Second, the CRUT would generate a projected cumulative cash flow of $35.4 million that would flow back into Rich's main portfolio. Third, income and realized capital gains generated within the CRUT would not be subject to tax until distributed. The assets remaining in the CRUT are projected to grow to $29 million by the end of I.M. Rich's life. This amount would flow directly to the charity but would be insufficient to meet his stated goal of a $38 million charitable contribution, so an additional $9 million must come from his testamentary estate. The remaining assets of $206 million would be taxed at 55 percent, leaving an estimated $92.8 million to go to Rich's children.

Thus, although the CRUT is principally a charitable vehicle, it can also add value for Rich's children by deferring the payment of capital gains tax on the low-cost Fertilizer Company shares transferred to the CRUT. Rich's baseline case (no planning) would transfer $91.18 million to his children, whereas a CRUT with identical asset allocation would generate $92.86 million—an added value of $1.68 million arising simply from the value of a financial planning vehicle.

The Value of Proper Asset Location. The allocation of assets in Rich's main portfolio and in the CRUT are identical. Rich's investment advisor recognizes that because these two entities are taxed in different ways, varying the types of

investments placed in the CRUT may improve its effectiveness. Testing this assumption involves examining the impact that holding bonds in the CRUT would have on final wealth versus the impact that using aggressive assets would have. Note that in all scenarios examined, the aggregate asset allocation of Rich's combined portfolio (main account plus the CRUT) always remains at 40 percent bonds, 45 percent U.S. stocks, and 15 percent emerging market stock. As shown in **Table 3**, aggressive investments are clearly the best alternative. The value of the CRUT itself, relative to using no financial planning at all, would be $1.7 million. Funding the CRUT with aggressive assets would increase the value Rich can transfer to his children by $8.35 million. Thus the proper asset allocation can add significantly greater value than the value of the CRUT vehicle itself.

Table 3. Effect of CRUT Asset Allocation on Wealth Transfer

	CRUT Allocation				
	Bonds	U.S. Stocks	Emerging Market Stocks	Wealth Transfer to Children	Advantage over No CRUT
No CRUT	0 %	0 %	0 %	$91,183,286	—
Identically allocated CRUT	40	45	15	92,864,402	1,681,116
Conservatively allocated CRUT	100	0	0	90,264,928	-918,358
Aggressively allocated CRUT	0	35	65	99,538,965	8,355,679

Table 4. Effect of GRAT Asset Allocation on Wealth Transfer

	GRAT Allocation				
	Bonds	U.S. Stocks	Emerging Market Stocks	Wealth Transfer to Children	Advantage over No GRAT
No GRAT	0 %	0 %	0 %	$91,183,286	—
Identically allocated GRAT	40	45	15	95,661,874	4,478,588
Conservatively allocated GRAT	100	0	0	91,183,286	—
Aggressively allocated GRAT	0	35	65	113,230,328	22,047,042

A second strategy that has been suggested to Rich is to transfer $25 million to a 10-year GRAT. Like the CRUT, this strategy would generate cash flow back into Rich's main portfolio (a projected $30.7 million in this case). Unlike the CRUT, however, a GRAT would not result in the creation of a charitable deduction or in the deferral of capital gains taxes. Also, assets remaining in the GRAT at the end of its 10-year term need not be turned over to charity but instead could be transferred to Rich's children free of estate taxes. If the GRAT and the main portfolio share an identical asset allocation, at the end of the term, the GRAT would generate an additional value for Rich's children of $4.5 million relative to no financial planning. Under this set of assumptions, the GRAT is a more effective wealth transfer tool than the CRUT.

As with the CRUT transaction, varying the types of investments within the GRAT may improve the effectiveness of the strategy. As shown in **Table 4**, placing aggressive assets within the GRAT would generate a sizeable $22 million advantage over using no financial planning and approximately $18 million of additional value relative to a GRAT that has an allocation identical to the main portfolio. In short, proper asset allocation can generate a nearly fivefold increase in the value of the underlying financial planning strategy.

Finally, Rich wonders what would happen if he ignored all of these complex techniques and simply transferred a $25 million gift to his children today and paid the gift tax? As shown in **Table 5**, the combined ending value of Rich's portfolio and the children's portfolio totals $122 million. Compared with no financial planning, which would transfer about $91 million to the children, simply transferring a $25 million gift, paying the gift taxes today, and identically investing the two portfolios would add value of $31 million.

Table 5. Total Wealth Transfer for Gifting Approach

	Year 1	Year 2	Year 2020
Main portfolio			
Starting balance	$100,000,000	$45,212,424	$84,534,364
Annual spending	-1,000,000	-1,000,000	-1,000,000
Gift to children	-25,000,000	—	—
Investment income	2,257,000	1,343,296	1,386,515
Capital gains	3,385,500	1,845,013	2,004,914
Fees and taxes	-20,680,076	-717,126	-324,740
Estate tax	-13,750,000	—	-26,146,603
Charitable gift	—	—	-38,000,000
Ending balance	$45,212,424	$46,683,607	$22,454,450
Children's portfolio			
Starting balance	$25,000,000	$26,661,681	$93,133,153
Investment income	762,500	817,572	2,868,617
Capital gains	1,143,750	1,370,301	5,222,772
Fees and taxes	-244,569	-301,947	-1,366,823
Ending balance	$26,661,681	$28,547,607	$99,857,719
Total Wealth Transfer	—	—	$122,312,169

As with the other strategies examined in this presentation, varying the allocation of the aggressive and conservative assets for Rich's portfolio and his children's portfolio can add significant value. As shown in **Table 6**, loading the children's portfolio up with more aggressive investments would generate $49 million of additional value versus no planning and nearly $18 million more than with identical allocations. Again, note that for each type of allocation to the children's portfolio identical, conservative, and aggressive the risk profile of

Rich's aggregate portfolio (that is I.M. Rich's portfolio plus the children's) is the same.

Table 6. Effect of Asset Allocation on Children's Portfolio

	Children's Portfolio				
	Bonds	U.S. Stocks	Emerging Market Stocks	Wealth Transfer to Children	Advantage over No Planning
No Planning	0 %	0 %	0 %	$91,183,286	—
Identical children's portfolio	40	45	15	122,312,169	31,128,883
Conservative children's portfolio	100	0	0	105,582,443	14,399,157
Aggressive children's portfolio	0	Varies*	Varies*	140,580,700	49,397,414

* In order to ensure that the portfolios (I.M. Rich's plus his children's) were, in the aggregate, always allocated 40 percent to bonds, 45 percent to U.S. stocks, and 15 percent to emerging market stocks, it was necessary to vary the allocation within the children's portfolio over time.

Summary

Estate taxes destroy multigenerational wealth. Preserving the value of a portfolio for two generations is difficult, and for three generations, nearly impossible. Financial planning can add substantial value, whether one chooses the simple option of transferring wealth to the children today or uses one of the more complex strategies, such as GRATs or CRUTs.

Proper asset allocation substantially increases the effectiveness of financial planning techniques. Investment professionals should gain a thorough understanding of the mechanics and tax characteristics of tax and estate planning vehicles and should allocate assets properly among them.

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(This paper was presented by Gregory R. Friedman, a Principal at Greycourt, at the Association for Investment Management and Research's second annual private client conference.)