

## Steve Leimberg's Estate Planning Email Newsletter - Archive Message #3086

**Date:** 20-Dec-23  
**From:** Steve Leimberg's Estate Planning Newsletter  
**Subject:** [Thomas J. Pauloski: Overrated - How Surging Interest Rates and Slow Growth May Radically Change Wealth Transfer Planning](#)

*“Although interest rates have spiked recently, they remain relatively low by historical standards. Nevertheless, capital is no longer virtually free, as it was at times in 2020 and 2021. And future investment returns are likely to pale in comparison to historical returns. As a result, the spread between expected returns and cost of capital is the lowest it’s been in many years.*

*Estate planners who employ leveraged strategies, like installment sales to IGTs and GRATs, should do so advisedly, with a primary focus on asset classes that are likely substantially to outperform traditional stocks and bonds. Strategies that do not depend on leverage, such as gifts and valuation discounts, are much more valuable when interest rates rise, and may resurge to the forefront. So may strategies like QPRTs that just work more efficiently in a high-interest-rate environment. Old standbys, like short-term rolling GRATs, CRUTs, and PPLI, should remain relatively unaffected.*

*Each client’s circumstances are unique, so a deep, quantitative, customized analysis by a multidisciplinary team of legal, tax, insurance, valuation, and financial experts is essential. What’s worked well in the recent past may not be the right choice today. Clients are depending on us, now more than ever, to make the best decisions on their behalf.”*

**Thomas Pauloski** provides members with timely and important commentary that reviews how surging interest rates and slow growth may radically change wealth transfer planning.

**Thomas J. Pauloski** is **Senior National Director of the Institute for Tax, Trusts, and Estates**, a research division of **Bernstein Private Wealth Management**. He works with private clients and their advisors on wealth transfer strategies, focusing on tax-efficient wealth management and asset allocation decisions. Previously, Tom was a partner at the Chicago law firm of Winston & Strawn LLP, where he concentrated his practice in estate, tax, and business planning. Tom also has been a member of the Chicago law firm of Levin & Schreder, Ltd., a Vice President in the Private Client Group of Zurich Life in Long Grove, Illinois, and a partner at the Chicago law firm of Schiff Hardin & Waite.

Tom is a nationally known speaker on estate planning, tax, and insurance issues, and has written numerous articles and continuing legal education materials on estate planning topics. He serves on the faculty of the American Bankers Association National Trust and National Graduate Trust Schools, and has served on the adjunct faculty of the Cannon Financial Institute Schools. Tom has been an adjunct professor at Loyola University Chicago School of Law and has taught estate planning classes at Northwestern University Law School. Tom also has served on the editorial board of Trusts & Estates magazine. He retired from the United States Naval Reserve in 2003, after 21 years of service.

Tom received his bachelor of science degree in environmental engineering from Northwestern University, and his juris doctor, magna cum laude, from Loyola University Chicago School of Law, where he served as editor-in-chief of the Loyola Law Journal.

Here is his commentary:

### **EXECUTIVE SUMMARY:**

Leveraged wealth transfer strategies—like grantor retained annuity trusts (GRATs) and installment sales to irrevocable (“intentionally defective”) grantor trusts (IGTs)—were extremely effective during an extended period when interest rates were at or near all-time lows, and the cost of capital was minimal. But beginning in March 2022, the Federal Reserve Board (Fed) announced significant interest rate increases to help tame runaway inflation, and the capital markets responded accordingly: Bond values plummeted, and Treasury yields spiked. Indirectly, those higher rates increased the cost of capital, thereby reducing the effectiveness of GRATs, installment sales, and other strategies that rely on leverage.

From a wealth transfer perspective, the question becomes, “What now?” Despite increases, interest rates remain relatively low by historical standards, but to complete the picture, we need to compare the cost of capital to expected returns on investment. The lower that spread, the more capital we must lend or sell to the IGT to achieve the same expected wealth transfer outcome.

Given these conditions, which wealth transfer strategies may be adversely affected, which strategies may thrive, and which strategies are functionally impervious? In certain respects, the next generation of wealth transfer plans may look more like those created in the 1990s than like recent plans, which have been driven largely by near-zero capital costs.

## COMMENT:

### I. Estate Planning Arbitrage

#### A. “Leveraged” Transfers

Until recently, low interest rates have been a key driver—arguably *the* key driver—of lifetime wealth transfer strategies. Those rates—specifically, yields on Treasury securities—drove estate planning for many years because the tax laws limit how much individuals can give to their children and grandchildren free of gift and estate tax. As estate planning evolved during a protracted era of low interest rates, most ultrahigh-net-worth families didn’t give away much, if any, of their current wealth during life. Rather, they gave away the future *growth* of that existing wealth, transferring principal only to the extent necessary to fuel leveraged strategies that took advantage of historically low interest rates. And they retained the obligation to pay income taxes on that growth—free of any gift tax consequence<sup>[1]</sup>—by making liberal use of IGTs as wealth transfer conduits.

#### 1. Treasury Yields and the Applicable Federal Rates (AFRs)

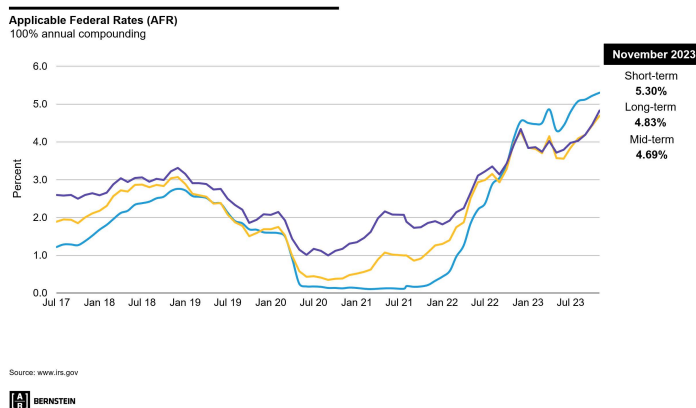
But times have changed: Bond yields have increased sharply, impacting the leveragability of wealth. The Treasury yield curve, upon which the AFRs are based, reflects investor expectations for future economic growth over the near term (represented by the short end of the curve), the intermediate term (middle of the curve), and the long term (far end of the curve). The Fed has direct control over only the very short end of the yield curve through the Fed funds rate, which has increased from essentially zero during the COVID-19 pandemic to 5.25%–5.5% today. The Fed’s recent action aims to curb inflation, which appears to have peaked at 9.1% for the 12-month period from July 2021 through June 2022.

The net result of this upward pressure from the Fed pushing at the short end, and the broader market holding the line at the long end, is a very *flat* yield curve for all but very short-term Treasuries. Today, the spread between intermediate- and long-term Treasury yields is nearly zero.

Complicating things even further, the Treasury yield curve is also inverted. *Inversion* occurs when the yield on a short- or intermediate-term bond is greater than the yield on longer-term bonds. Sometimes, an inverted yield curve can be an indicator of a pending recession, although that doesn’t seem to be the case today.

To translate the immediate effect of the Treasury yield curve on wealth transfer planning, we can look at month-by-month changes in the short-, mid-, and long-term AFRs from July 2017 through December 2023 (**Display 1**). Most attorneys use these rates to determine the minimum amount of interest that must be charged when family members lend money to one another or to trusts established for the benefit of family members. Insufficient interest may result in an imputed gift or taxable income, or both, depending upon the circumstances.

**Display 1: Rising Interest Rates, and a Flat, “Inverted” Yield Curve, Present Challenges ... And Perhaps Opportunities**



Starting on the left-hand side of Display 1, the bottom line represents the short-term AFR, which governs intrafamily loans having terms of three years or less; the middle line represents the mid-term AFR, which governs loans that have terms of greater than three years, but no more than nine years; and the top line represents the long-term AFR, which governs loan terms of greater than nine years. The short-, mid- and long-term AFRs reflect recent yields on comparable Treasury securities; thus, for example, the mid-term AFR reflects recent, average yields on securities that mature in three to nine years.

The Treasury Department resets each AFR monthly, but there is a bit of a time lag. For example, December AFRs are based on daily Treasury yields measured from October 16 through November 15. Average yields for each mid-month to mid-month period are compiled and announced by Treasury in a revenue ruling that is published on or about the 16th of

each month, effective for transactions completed in the following month.

Now, if you stare at Display 1 long enough, you'll notice several things:

- First, the general rate trend is sharply upward for all three AFRs, with some flattening in recent months as the Fed has slowed the pace of rate increases.
- Second, the mid- and long-term AFR lines converge on the right-hand side of the display. In other words, current Treasury yields for intermediate- and longer-term securities are about the same regardless of the maturity of the bond. This convergence of AFRs is, in effect, the estate planning version of a flat yield curve.
- Third, currently (in December 2023), the short-term AFR is higher than the mid- and long-term AFRs. Due to this inversion, an investor is being paid more interest to hold a short-term bond than an intermediate- or long-term bond.

Why are sharply higher interest rates, and a relatively flat, inverted yield curve, potentially important? Ordinarily, the mid-term AFR provides the best combination of a relatively low interest rate combined with the ability to lock that rate in for a considerable period, up to nine years. Today, however, it's the *long*-term AFR that arguably is the most compelling of the three: Depending upon a family's circumstances, it may be possible for a patriarch or matriarch to lend money (or sell assets) to an IGT in exchange for a note that matures in 15, 20, or even 30 years at a fixed interest rate that is slightly higher than the mid-term AFR for transactions completed in December 2023. If the trustee of that trust can invest for a total return that handily beats that interest rate, all that excess growth should (1) avoid the claims of any trust beneficiary's creditors, including a spouse in the event of a divorce; and (2) avoid estate tax at the deaths of the matriarch and patriarch, the children, and potentially generations beyond. Further, locking in the long-term AFR now should not preclude the possibility of renegotiating the debt, should the cost of capital become more attractive in the future.

## 2. Cost of Capital

But herein lies the problem: Until recently, the cost of capital, as reflected by the AFRs, was nearly zero. A client who may hesitate to give away \$12.92 million—the basic exclusion amount for 2023<sup>[2]</sup>—could, in a low-interest-rate environment, instead take the initial step of *lending* that amount to an IGT for the benefit of a spouse (if appropriate), children, and grandchildren at the short-, mid-, or long-term AFR. If the cost of capital were effectively zero, the promissory note received in return by the lender could be thought of as a free (or nearly free) option to complete the gift: At any time during the note term, the client could forgive the debt, in whole or in part, with the stroke of a pen. Assuming no near-term changes to the current tax laws, the lender could wait until December 31, 2025, to forgive up to an inflation-indexed \$12.92 million of debt, without paying gift tax and at a negligible cost to the trust.

Today, however, the cost of capital is *not* zero: At best, it's nearly 5% per year, and thus the carrying cost of the "option" is no longer negligible. The trustee must invest the borrowed capital in assets that (1) allow for interest to be paid on the debt, preferably not less frequently than annually; and (2) provide substantial additional return, so that the trust will profit from the estate planning arbitrage.

For example, consider a three-year loan of \$11.7 million (in lieu of a gift of that amount) made by the grantor to an IGT in July 2021—just over two years ago—at the then short-term AFR of 0.12%. The grantor wasn't sure whether she wanted to make a gift of that amount, so instead, she structured the transfer as a loan. In doing so, she retained the option to convert the debt into a gift simply by forgiving the note, in whole or in part, at any time during its three-year term. While she ruminated, the trustee invested the borrowed capital, \$11.7 million, in a portfolio of stocks, bonds, and alternative investments; the annual cost of capital to the trust was only \$14,040. If the portfolio's pre-tax annual return were 6%—and the grantor is paying all income taxes—the IGT would have nearly \$2.2 million of corpus in July 2024, after paying annual interest installments and the entire principal amount upon maturity, and the grantor would not have had to use any of her gift and estate tax exclusion.

Fast forward to today: Assume that the grantor lends the same \$11.7 million (recognizing that the current gift and estate tax exclusion is \$1.22 million higher than that amount) to the IGT in substantially the same way, except that she must charge the trust at least 4.82% annual interest—the mid-term AFR for December 2023. (Recall that due to the current yield curve inversion, the December 2023 mid-term AFR is slightly less than the long-term AFR, and substantially less than the short-term AFR.) In this case, the annual cost of capital is a whopping \$563,940, nearly 40x the required annual interest payment for a short-term loan made just 29 months earlier. The projected amount remaining in the IGT three years hence—assuming that the debt were then repaid in full—would be just under \$440,000. That is about 20% of the expected remainder for the three-year July 2021 loan, again assuming a pretax annual return of 6%. To replicate the arbitrage of the earlier loan, today's grantor would have to lend more than \$58 million—roughly five times more capital—to the IGT, to achieve the same expected outcome.

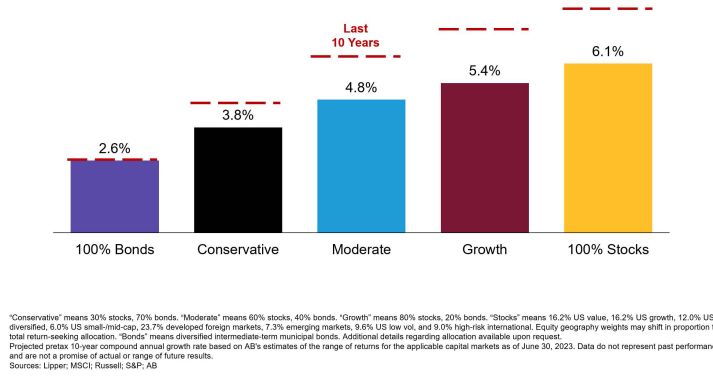
## 3. Diminished Return Expectations

All this would be merely academic if we expected strong near-term returns from the capital markets. After all, stocks historically have returned about 10% per year on average; bonds, about 4.5% albeit substantially less than that in the past

decade. But over the next 10 years, Bernstein expects a combination of global stocks and municipal bonds to underperform historical norms by substantial margins (**Display 2**). True, interest rates are still somewhat low by historical standards, but return expectations are low as well. As a result, using estate planning arbitrage to fuel wealth transfer is a much less attractive strategy today than at any other time in recent memory.

**Display 2: Future Investment Returns Are Likely to Be Lower than Recent Returns**

Median 10-Year Projections Versus 10-Year Historical Returns\*



Investors use the phrase *equity risk premium* (ERP) to refer to the additional return they expect when investing in relatively risky stocks, rather than relatively risk-free bonds.<sup>[3]</sup> Historically, the ERP has averaged about 4% per year depending upon the methodology, but higher interest rates, coupled with below-normal expectations for equity returns, should give stock investors considerable pause.

Similarly, professional advisors and their clients should be more selective in their use of leveraged wealth transfer strategies, as a substantial economic benefit may be much harder to achieve in the future than in the recent past. With the annual cost of capital currently about 5% and the expected annual return of a global stock portfolio about 6%, an installment sale of marketable stocks today will need plenty of extra return to service the debt and produce a substantial economic benefit. Today, a good rule of thumb is to transfer about five times the value of marketable securities in an installment sale as in a gift to achieve the same wealth transfer outcome. Consider this: With a gift, an IGT earns *and keeps* a 6% annual portfolio return; in a sale, the trustee must give back more than four-fifths of that return to the grantor each year as interest.

**B. Paradigm Shift**

As a result, the incredibly high (for now) basic exclusion amount—tempered perhaps by income tax planning considerations for older clients—has emerged as the key driver of current estate planning. And the exclusion is indexed for inflation, which continues to move, albeit a bit more slowly of late, in a direction that is favorable to clients. This favorable movement seems likely to continue until after 2025, when most of the Tax Cuts and Jobs Act of 2017 (TCJA)—including the current “double exclusion”—is scheduled to revert to its pre-2018 state.<sup>[4]</sup>

**II. Which Strategies Should We Favor—and Which Might We Avoid—in the Current Environment?**

**A. Overview**

Today, interest rates are higher and future investment returns are expected to be below historical norms. That’s an inauspicious combination for wealth transfer planning. In many cases, it may be necessary to “overstuff” leveraged estate planning strategies to accomplish results that are comparable to those investors have enjoyed over the past decade or so. But higher interest rates affect each wealth transfer strategy differently. Let’s look at the likely winners and losers, as well as those strategies that are somewhat impervious to higher costs of capital.

**B. Strategies That May Struggle**

Strategies that rely on leverage are significantly less attractive today than they were just two years ago. For example:

**1. Installment Sale**

**Challenges:** As previously discussed, a portfolio of publicly traded securities may struggle to outperform the current AFRs over the next decade. Clients may be reticent to redeploy (albeit temporarily) the additional capital necessary to produce the desired wealth transfer outcome.

*Opportunities:* An installment sale may still be appropriate for asset classes that are expected to substantially outperform publicly traded stocks and bonds; private equity and middle-market direct lending investments come immediately to mind. Valuation discounts, when appropriate, can help (see below). As these investments may not have a readily ascertainable fair market value, consider using a defined value clause, which automatically adjusts the principal amount of the note to reflect any valuation adjustment that may be made on audit. Arguably, an installment sale is superior to a gift or a GRAT when transferring assets to a multigenerational trust, as any GST exemption allocated relates only to the “seed” gift that is made when the IGT is established, not to assets sold to the trust in a subsequent transaction. And if the yield curve remains relatively flat, consider locking in the long-term AFR for a period of around 20 years in an appropriate case. If rates decline, perhaps that long-term note could be renegotiated, in whole or in part, to a lower AFR in the future.

## 2. Grantor Retained Annuity Trust (GRAT)

*Challenges:* A single GRAT faces the same arbitrage challenge as an installment sale, except that the cost of capital is even higher: The current (December 2023) Section 7520 rate “hurdle” is 5.8%, nearly a full percentage point higher than the mid-term AFR. Further, a GRAT often requires much higher annual payments to the grantor than an installment sale, resulting in greater sensitivity to early investment losses. Valuation discounts generally don’t help a GRAT much, since (presumably) the same discount taken when assets were contributed to the GRAT must be taken as assets are paid back to the grantor each year.<sup>[5]</sup>

*Opportunities:* Unlike an installment sale or gift, economic failure of a “zeroed-out” GRAT has no adverse transfer tax consequence: No exclusion is used to establish such a GRAT, and the assets are merely returned to the grantor over the annuity term. So, while a GRAT may have a higher fail rate than an installment sale of an equivalent term, the consequences of failure are minimal, which may make a GRAT more suitable than a sale or gift for high-risk, high-potential-return asset classes, like venture capital. A short-term (say, two- or three-year) GRAT also may be appropriate for a business owner who expects to sell to a third party within the next 12 months, but timing is crucial. Fund the GRAT too early, and the trustee may need to return a substantial portion of the ownership interests to the grantor at a substantially higher valuation; wait too long, and the fair market value of the stock contributed to the GRAT may be equal or very close to the anticipated transaction price.

## 3. Charitable Lead Annuity Trust (CLAT)

*Challenges:* Like a GRAT, its charitable cousin, the CLAT is currently much less likely to produce a positive remainder at the end of the charitable term than would have been the case a year or two ago. Given that risk, always zero out an inter vivos CLAT, especially in the current high interest-rate environment. If the CLAT fails, the grantor can make up for failed distributions at the tail end of the annuity term out of pocket and receive additional income tax charitable deductions for those contributions. Estate planners also need to be careful not to oversell the potential benefits of a popular estate planning strategy, a testamentary CLAT (T-CLAT). It’s true that a zeroed-out T-CLAT should avoid estate tax, but whether the noncharitable beneficiaries will receive anything from the arrangement at the end of the annuity term is very much dependent on interest rates. A 2012 Bernstein study found that under “normal” (not current) market conditions, a 20-year T-CLAT funded when the Section 7520 rate is in the lowest quartile has a 92% chance of producing a positive remainder for the (by then very old) noncharitable beneficiaries. However, a T-CLAT funded when the Section 7520 rate is in the highest quartile is essentially a coin flip—a 51% chance that the remainder beneficiaries will receive anything at all. No one can predict what interest rates will be upon the future death of a family’s matriarch or patriarch, so the potential success of this “zero-estate-tax” strategy is very much at the whim of the capital markets. Funding the T-CLAT with a discounted note, rather than directly with marketable securities, can help improve the odds of success, especially when death occurs at a time of higher-than-normal interest rates.<sup>[6]</sup>

*Opportunity:* A CLAT has a peculiar advantage over a GRAT in a rising interest-rate environment: The grantor of a CLAT can look back up to two months to establish the Section 7520 rate for the trust. For example, the Section 7520 rate, which is 5.8% in December 2023, was just 5.4% in October. A December 2023 GRAT would be stuck with a 5.8% hurdle rate, but a December CLAT could still use the 5.4% October rate. This bit of tax trivia provides an advantage only in a rising rate environment; when rates are stable or falling, the two-month lookback provides no benefit.

## B. Strategies That May Thrive

Strategies that either don’t rely on or improve leverage—or that excel in high-interest-rate environments—are more attractive today than in 2021. Consider:

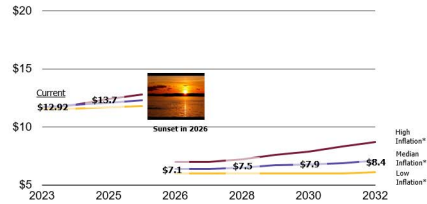
### 1. Gifts

The basic exclusion amount now stands at an inflation-adjusted \$12.92 million per person, \$25.84 million per couple. Under current law, the exclusion will continue to grow with inflation until 2026, when sunset of the TCJA will cause it to be halved, absent action by a future Congress. The exclusion amount will increase to \$13.61 million in 2024.<sup>[7]</sup> Bernstein expects the exclusion amount to increase to roughly \$14 million in 2025, but then drop to about \$7.2 million in 2026

(Display 3). If all this holds, clients who can afford to do so have just over two years to take advantage of the currently enhanced exclusion amount.

**Display 3: The Basic Exclusion Amount Is Likely to Decline in 2026**

(\$ Millions, Nominal)\*



\*Amounts displayed are based upon AB's projections of the 10th ("high"), 50th ("median"), and 90th ("low") percentile outcomes for chained CPI-U. Based on AB's estimates of the range of chained CPI-U over the periods analyzed. Data do not represent past performance and are not a promise of actual or range of future results. Source: AB



Over the past several years, we have encouraged clients to take advantage of the extremely low cost of capital by selling (or lending), rather than giving, assets to an IGT. The rationale? In part, some clients were concerned about the effect that a large gift might have on the future productivity of their descendants, and a sale at those formerly low rates would allow them to transfer only the future growth of assets, not the assets themselves. The note that they took back in the exchange provided both a financial *and psychological* incentive. But with interest rates settled in today at much higher levels, a sale is a less attractive way to hedge against demotivating younger generations. Others were worried that Congress might retroactively reduce the basic exclusion amount; a sale allowed them to wait and see. (As we now know, Congress did not retroactively reduce the exclusion, and many of those clients accordingly forgave debt at the end of 2021 to complete those gifts.) Now, with the rising cost of capital, coupled with low return expectations relative to history, it's time for a shift.

One important sidebar: If the exclusion amount is halved as scheduled in 2026, current Treasury Regulations essentially provide that the cut will come first from each taxpayer's *unused* exclusion, without any "clawback" penalty for those who used more than the reset exclusion amount. The amount and timing of previous gifts matter, but for now, let's set aside those details. The essential point is that, to take substantial advantage of the enhanced exclusion amount, clients will need to give away more than \$7.2 million—if the foregoing inflation projection is correct. As a result, some married couples may not want to elect gift-splitting. Assume, for example, that one spouse gives \$12.92 million of investment assets to an IGT in 2023; further assume that, as a couple, they cannot afford to give away more. If the nondonor spouse were to consent to splitting that gift, each spouse would be deemed to have contributed \$6.46 million. When the basic exclusion amount is slashed in 2026, it first would take away each spouse's unused exclusion. That would leave each with a negligible exclusion amount (roughly \$700,000) equal to one-half of the statutory inflation adjustments in 2024, 2025, and 2026. Instead, consider having the donor spouse alone report the gift, without splitting. True, that spouse will be left with a negligible amount of exclusion in 2026; but the other spouse will have the entire—albeit halved—exclusion of about \$7.2 million, which can be used for future transfers.

**2. Valuation Discount**

For the past decade, in an era of historically low interest rates, valuation discounts seemed useful but largely unnecessary. The reason? Leveraged strategies, like installment sales and GRATs, are extremely scalable. Most estate planning practitioners believe that a 10% gift of "seed" capital is sufficient to establish the creditworthiness of an IGT prior to an installment sale. If true, then a gift in trust of \$12.92 million (the current basic exclusion amount) will support a subsequent sale of nine times that amount—more than \$116 million of value. GRATs require no seed capital, so they are infinitely scalable. Under these circumstances, why tempt fate by asserting a 30% valuation discount? Why not simply sell 30% more nondiscounted assets to an IGT or contribute 30% more nondiscounted assets to a GRAT, and achieve the same economic outcome? Take the additional step of hedging out the mortality risk inherent in leveraged strategies—typically with life insurance—and you're done.

Today, however, scalability comes with a significant cost, and a valuation discount mitigates that cost. For example, assume that an investor wants to sell \$10 million of assets to an IGT in exchange for an installment note that bears interest at 4.82% per year (the mid-term AFR for December 2023). The annual cost of capital to the trust in this case is \$482,000. But if those assets instead were packed into a family limited liability company (LLC), for example, and if a nonvoting member interest in that entity were to be discounted by 30% due to lack of marketability and lack of control, the annual cost of capital in the installment sale would decrease to \$337,400, roughly equivalent to annual interest of 3.37% in a sale of nondiscounted assets. Thus, a valuation discount can mitigate the effect of high interest rates. [8]



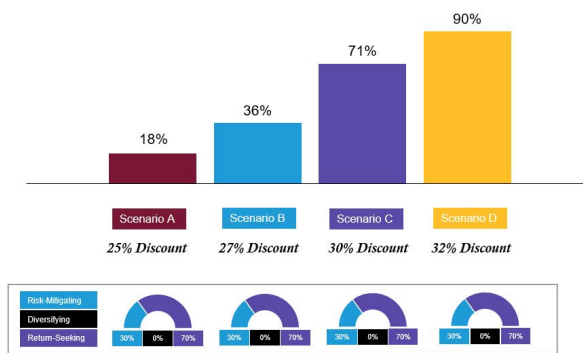
In addition, a discount, if successfully defended, produces an immediate benefit: There is no mortality risk, unlike an installment sale or GRAT. In the current environment, a defensible valuation discount can help offset the economic and mortality risks posed by installment sales and GRATs. Continuing the previous example, a \$3 million reduction in value saves \$1.2 million of transfer tax that otherwise might be imposed at a rate of 40%. And that economic benefit is captured immediately, if the discount can be successfully defended.

A valuation discount can be even more useful when dealing with assets that are subject to debt. Consider the case of a real estate investor (let's call him Lando) who owns a 45% interest in a limited partnership (LP) that owns a shopping center. Assume that the value of the property is 2x, the value of the property net of outstanding debt is x, and Lando's 45% interest in the LP entitles him to a minority interest and lack of marketability discount of 25%. Under these circumstances, Lando's LP interest for transfer tax purposes is worth only about 34%—not 45%—of x because of the discount. Further assume that annual cash flow net of debt service is just under 5% of x. Finally, assume that Lando would like to sell his LP interest to an IGT in exchange for a nine-year, interest-only promissory note at the mid-term AFR, which at the time (May 2017) was just over 2%. What is the probability that Lando's share of the net cash flow from the shopping center will be adequate to pay off the note in full within nine years? And how sensitive is that result to the level of valuation discount?

The results are startling (**Display 4**). At a 25% valuation discount, there is less than a one-in-five chance that the net cash flow, supplemented by investment returns, will be adequate to pay the note off in full within nine years. But bump that discount up just two percentage points—to 27%—and the probability of success doubles. A 5% bump in the valuation discount—to 30%—nearly quadruples the probability of success. And if the family can assert and defend a 32% valuation discount, the probability of full payment at maturity in nine years becomes 90%!

**Display 4: Valuation Discounts Are More Impactful When Transferring Leveraged Assets**

Probability of Fully Repaying Interest-Only Installment Note, Year 9\*



\*Probability that at least \$1 will remain in trust in nine years, after all annual interest payments, plus full repayment of principal at maturity. Based on ABI's 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 future results. ABI is not a legal, tax, estate, or insurance advisor. Investors should consult these professionals as appropriate before making any decisions.  
Source: ABI BERNSTEIN

This example illustrates an important point: Optimistic valuation discount planning carries risks, but there are cases when even a modest increase in the discount can produce an outsized benefit. In the illustrated case, the debt on the underlying real estate magnifies the potential benefit. The relationship isn't linear; it's exponential, as illustrated in Display 4.

**3. Preferred (aka "Frozen") Limited Partnership**

Back in 1990, Congress enacted Section 2701 of the Internal Revenue Code, which provides (in part and in plain English) that the gift tax value of a "common" interest in a closely held partnership or corporation that is transferred to a descendant or spouse of a descendant generally includes the value of any "preferred" interest retained by the transferor or the transferor's spouse. An exception (one of many) is made when the preferred return is "cumulative" and has a fixed relationship to a market rate of interest. Thus, if the preferred return of a family entity reflects the preferred return that would be paid to an outside investor in a similar enterprise at arms' length (and meets the other statutory requirements), the value of the transferred common interest need *not* include the value of the retained preferred interest.

In the early 1990s, when Chapter 14 was new and interest rates were high, families typically didn't create a family limited partnership (FLP) with a single class of limited partner interests, and then sell some of those interests to an IGT in exchange for a note. Rather, the FLP would have two classes of limited partner interests: preferred and common. Mom and dad would retain the preferred, which would entitle them to a market rate return of, say, 7% per year, and they would give the common interests to a trust for their descendants. If mom and dad transferred \$11.2 million to the FLP and retained the right to receive a \$700,000 preferred return each year, the value of preferred interests necessary to support that return would be \$10 million, and the value of the common interests given to the multigenerational trust would be the balance, \$1.2 million (ignoring for the moment any applicable valuation discount), which happened to coincide with mom and dad's combined unified credit equivalent at the time. To the extent that the FLP's investment return exceeded \$700,000 in a given year, that excess would inure to the benefit of the common interests, held by the multigenerational trust. As interest

rates fell and installment sales to IGTs became more popular, this “estate freeze” strategy fell out of vogue in many circles.

With interest rates rising, could preferred FLPs return to prominence, perhaps in lieu of installment sales? There is growing concern among attorneys nationwide about intrafamily promissory notes that may be on the balance sheet of a client at death. Why? Perhaps the note was renegotiated several times during the decedent’s lifetime as interest rates declined, and the attorney does not wish to defend that series of transactions. Perhaps periodic interest payments were inadvertently missed. Perhaps the attorney is concerned about the income tax consequences of debt repayment after the holder’s death. Whatever the circumstances, many attorneys today are ruminating about outstanding intrafamily debt.

Arguably, the easiest way to eliminate that debt is to have the holder of the note use some or all of her remaining gift and estate tax exclusion to forgive the obligation. But the holder may not have sufficient exclusion available to forgive the entire debt. And the cost of debt forgiveness may be substantial, especially if the fixed interest rate on the note is low. In some cases, it may be preferable—purely from a financial perspective—to continue making minimal annual payments prior to maturity at a favorable interest rate and to assert a discount against the outstanding note balance if that rate is substantially less than prevailing interest rates at the holder’s death.

Another possibility may be to exchange the note for the IGT’s unsecured promise to pay the grantor a fixed sum each year for the balance of her life: a *private annuity*, valued in accordance with IRS actuarial tables at today’s Section 7520 rate. A potential benefit of this approach is that the debt instrument, which would be subject to estate tax upon the grantor’s death (and perhaps to income tax then or thereafter), would be displaced by a private annuity, which has an estate tax value of zero and no lingering income tax consequences to the estate. A potential detriment is high required annuity payments back to the grantor, due to a combination of today’s inflated Section 7520 rate (5.8% in December 2023) and the IRS’s view of an annuitant’s longevity as reflected in its actuarial tables.<sup>[9]</sup> This strategy may backfire if the annuitant were to collect those oversized annuities over a very long period of time.

A third way to eliminate intrafamily debt may be to (i) establish an LLC, (ii) have the grantor contribute her note to the LLC in exchange for a preferred member interest, and (iii) have the IGT contribute investment assets (net of the outstanding debt) to the LLC in exchange for a common member interest. If the only two LLC members are the grantor and an IGT of which she is deemed owner under the grantor trust rules, the LLC may be a disregarded entity, so there should be no income tax consequences associated with this exchange. Absent further planning, the grantor’s preferred member interest would be subject to estate tax upon her death, and the cumulative preferred return paid to the grantor may exceed the cumulative interest payments that the grantor would have received under the promissory note. But liquidation of the preferred interest after the grantor’s death should have minimal, if any, income tax consequences, due to a step-up in the outside basis of the grantor’s member interest; that may not be true of liquidation of a promissory note held at death. And income tax consequences of postmortem sales of LLC assets could be substantially reduced due to a step-up of the inside basis of those assets if a Code Section 754 election is in effect; that inside basis step-up would not apply to nonvoting LLC interests sold to an IGT during the grantor’s lifetime and held there upon the grantor’s death.<sup>[10]</sup> Are these postmortem income tax benefits of a preferred member interest substantial enough to outweigh the potential benefits of a low-interest-rate note? Each case must be evaluated on its merits, but attorneys who are dealing with outstanding debt should at least consider the possibility of converting that debt into a preferred member interest.

#### 4. Qualified Personal Residence Trust (QPRT)

Some practitioners do not like QPRTs, especially in a low-interest-rate environment. But in an era of rising interest rates—and the potential halving of the basic exclusion amount in 2026—those who have disfavored QPRTs in the past are taking a fresh look.

When a QPRT is established, the grantor transfers an interest in a primary or secondary residence to an irrevocable trust in exchange for the right to live in the residence, rent-free, for a fixed term of years or until her prior death. At the end of that term, the residence typically passes to the grantor’s children, or to a trust for their benefit.

As provided in the regulations under Section 2702 of the Internal Revenue Code, at inception, the grantor’s retained interest in a QPRT is valued as if she were entitled to receive the income of the trust at the Section 7520 rate. When that rate is low, this calculation tends to undervalue the grantor’s retained interest and overvalue the children’s remainder interest. For example, consider a 65-year-old grantor who transfers a \$10 million residence to a QPRT, and retains the right to live in the residence, rent-free, for 15 years or until her prior death. If she had made that transfer in September 2020, when the Section 7520 rate was 0.4%, the value of the remainder gift would have been a whopping \$5.8 million. Just over three years later (December 2023), when the Section 7520 rate is 5.8%, the value of her gift would be less than half that amount, roughly \$2.7 million.

But there’s a catch: Because the residential real estate market soared after the pandemic, the value of the grantor’s residence is no longer \$10 million: It may be worth \$12 million or \$15 million, or more, in today’s market. (For reference, a residence value of \$21.9 million today results in the same remainder gift as a \$10 million residence value in September 2020.) In the financial assessment of a QPRT, the benefit of rising rates often is offset, at least in part, by the current inflated valuation of residential real estate. And what of *future* appreciation? Isn’t the advantage of lifetime wealth transfer



avoiding estate tax on future growth? How much further can we reasonably expect residential real estate to appreciate from today's lofty values?

When transferring a highly appreciated interest in a residence, be sure to compare the expected estate tax savings to the potential income tax cost of forgoing a step-up in basis at the grantor's death, assuming that she survives the income term of the QPRT. Moreover, a QPRT may trigger a reassessment of the home's value for property tax purposes. In California, for example, a property's assessed value cannot increase by more than 2% per year, unless there is a change of ownership or new construction. The change of ownership that occurs at the end of the income term of the QPRT triggers a reassessment in California and other states.

And what about expenses associated with the residence after the income term of the QPRT? Regulations under Section 2702 severely restrict the amount of cash and other nonresidential investments that the trustee may retain during the income term. Those regulations cease to apply thereafter (for the most part), but necessary capital to pay the future owner's proper expenses may require additional gifts or loans, possibly at a time when the grantor has little or no remaining exclusion, and interest rates are high. A grantor who wishes to remain in the residence after the income term may need to pay fair rental value to the new "landlord," absent highly specialized planning.

As the deadline for halving the basic exclusion amount approaches, QPRTs are likely to reemerge as a popular topic of discussion. Often, estate planners propose a QPRT primarily as a use-it-or-lose-it strategy of last resort. Yet, higher interest rates make QPRTs appear more attractive, and they are likely to proliferate in the near term. Before implementing, carefully quantify the expected benefits, and objectively assess the potential quantitative, and qualitative, costs: In some cases, the trade-off may not be worthwhile.

### **C. Strategies That Aren't Affected**

Some strategies are relatively impervious to changes in interest rates. Three examples:

#### **1. Short-Term Rolling GRATs**

Although a single GRAT (see above) may struggle in the current high-interest-rate environment, a series of short-term (typically two-year) rolling GRATs funded with marketable stocks may be thought of as an all-weather strategy that can thrive in any interest-rate environment.

Here's how the strategy works: Client contributes marketable stocks to the first of what are expected to be a series of two-year GRATs. On the first anniversary date, the grantor receives her first annuity payment and immediately contributes those stocks to a new two-year GRAT. Each year, with each existing GRAT, she repeats this process. If the stocks in any one GRAT fail to beat the applicable Section 7520 rate, that GRAT fails, and the grantor receives her stocks back, without penalty. If the stocks in a GRAT beat the Section 7520 rate, the proceeds are swept into an IGT, typically for the benefit of the grantor's children. (Multigenerational GRATs are possible, but tricky.)

When looking at any one GRAT in isolation, a high Section 7520 rate is an obstacle to success. But Bernstein research shows that the primary benefit of a rolling strategy isn't that it produces a bunch of little "wins." The primary benefit is that the strategy on occasion produces an outsized reward. For example, assume that a client established a two-year, zeroed-out GRAT with a \$10 million portfolio of S&P 500 stocks<sup>[11]</sup> on January 1, 2020 (pre-pandemic), when the Section 7520 rate was 2%. The portfolio would have returned 18.4% in 2020 and 28.7% in 2021, resulting in a remainder value of nearly \$3.5 million. That's spectacular! But what if the Section 7520 rate had been 8%—four times higher than the January 2020 rate? The remainder value would have been more than \$2.4 million, still very compelling.

Because the stock market tends to perform well over time, a zeroed-out, long-term GRAT invested in stocks is more likely than not to succeed (i.e., produce a remainder value of at least one dollar). For that reason, certain advisors—especially those who espouse "simplicity"—may recommend a single, long-term GRAT rather than short-term, rolling GRATs. But that long-term GRAT will experience only one, long, volatile path of returns. What would happen if, for instance, the capital markets were to experience a significant downturn in the early years of the GRAT? Those early returns weigh more heavily on a GRAT's overall performance because a larger pool of assets experiences that downturn, thereby increasing future annuities as a percentage of current portfolio value. The rolling GRAT strategy works because it breaks one potentially dismal and volatile period of stock returns into a series of independent, separate, two-year paths.<sup>[12]</sup>

Here's the key: When stocks go up 15%, or 20%, or 30%, as they do from time to time, we don't care much what the Section 7520 rate happened to be at the inception of the GRAT. It's the occasional spectacular gains, often supplemented by a few, smaller wins, that drive this strategy, and those big rewards are powered by periodically strong stock performance, not low interest rates.

#### **2. Charitable Remainder Unitrust (CRUT)**

##### **a. The Case for CRUTs**

A CRUT is ostensibly a charitable strategy...but can it benefit a family that has only modest charitable intent?

Consider, for example, that the Treasury Department's actuarial tables are based on gender-neutral data for the general US population, not just the wealthiest Americans. As a result, the mandated method of computing a CRUT's beneficial interests tends to undervalue the grantor's retained interest and to overvalue charity's remainder interest.<sup>[13]</sup> Under the government's actuarial tables, the hypothetical present value of charity's remainder interest at inception of a CRUT must be at least 10% of the total value contributed. Yet, if we were to recalculate based upon recent actuarial data used by insurance companies when issuing policies to high-net-worth individuals, the present value of charity's interest would be significantly less.<sup>[14]</sup>

How can we harness this knowledge for clients with modest philanthropic intent who also wish to reduce income taxes? Think of a CRUT as a way to avoid immediate recognition of gain upon sale of a low-basis asset and instead spread that gain recognition over a client's lifetime—or over the joint lifetimes of the grantor and the grantor's spouse. The longer the grantor's *actual* (as opposed to *actuarial*) life expectancy, the more likely that paying tax on the deferred gain in smaller amounts over her lifetime will produce greater personal wealth than paying tax on the entire gain upfront and investing the after-tax proceeds in a taxable portfolio.<sup>[15]</sup> Charity's share of the pie is typically a small slice.

#### **b. CRUTs and Qualified Small Business Stock (QSBS)**

Consider the following example: Erin hopes to sell closely held stock in her business, a C corporation, to a third-party purchaser later this year in an all-cash transaction. Her shares meet the requirements for QSBS under Section 1202 of the Internal Revenue Code; thus, the first \$10 million of gain that Erin realizes in the transaction will be excluded from her gross income. In addition, Erin could transfer some of her excess shares—which may qualify for an *additional* \$10 million QSBS exclusion—to a CRUT. If the remainder beneficiary of the CRUT is a publicly supported charity, and not a private foundation, Erin should get an income tax charitable deduction of a fraction of the stock's fair market value at the time of its contribution (based upon the actuarially determined present value of charity's remainder interest).<sup>[16]</sup> Further, any capital gain incurred upon sale of those shares would be deferred over Erin's lifetime, rather than recognized in the current year.

For this strategy to succeed, Erin must transfer shares in her company to the CRUT well in advance of the transaction.<sup>[17]</sup> The CRUT would then hold those shares until the company is sold. At that time, the trustee of the CRUT would invest the cash proceeds and "book" the capital gain: As a charitable entity, a CRUT pays no income tax. After the sale and during Erin's lifetime, the CRUT would pay Erin a specified percentage of the trust assets each year. Each such payment typically would "carry out" some of the previously deferred capital gain tax liability to Erin on a Schedule K-1.

All this begs the question: Is a CRUT a separate taxpayer that qualifies for a separate QSBS exclusion? It would seem to qualify, but the statute is unclear. If it does so qualify—or if it's at least possible—some important issues need to be assessed.

First, how much QSBS should a business owner transfer to the CRUT in advance of an anticipated transaction? Ideally, she would transfer as much stock as is necessary to produce \$10 million of excludable gain. Transfer too little, and she potentially underutilizes some of the Section 1202 exclusion. Transfer too much, and the CRUT may spend years distributing higher-tier taxable income to her before getting to the lowest-tier, a tax-free return of excluded income. Ultimately, it's best to overshoot, but by just enough to support a few years of unitrust distributions to the grantor. If the IRS eventually determines that CRUTs do not qualify for a separate QSBS exclusion, little or no harm will have occurred in the first few years. That's because the trust's distributions will have carried out only previously deferred capital gain, meaning there should be no additional tax due, no interest, and no penalty. If it turns out that CRUTs *do* qualify for the QSBS exclusion, then tax-free distributions will become available, given prudent tax management of the trust's portfolio, within a few short years after inception.

Second, what should the term of the CRUT be? The answer depends, in part, on the tax advisor's conviction as to whether a CRUT qualifies as a separate taxpayer for purposes of the QSBS exclusion. If the CRUT so qualifies, the results of a recently published Bernstein study<sup>[18]</sup> indicate that it would take just three years of distributions from a five-year CRUT with a 37.5% annual unitrust payout to generate more personal wealth than a "No CRUT" base case. By comparison, it would take 13 years of distributions from a joint-life CRUT with an annual unitrust payout of 9.3% to surpass the personal wealth generated in the base scenario. Although CRUTs typically are designed to stretch the payouts to maximize tax deferral, the opposite may hold true for QSBS-funded CRUTs, since there is no (or substantially less) realized gain to be deferred. (A note of caution: If the CRUT fails to qualify for a separate QSBS exclusion—or if future tax laws eliminate or reduce the QSBS benefit—a longer noncharitable term generally will prove more protective of personal wealth.)

#### **c. Potential Drawbacks**

As with most estate planning strategies, there are potential downsides. With any CRUT, a portion of the sale proceeds will be effectively locked up for an extended period, especially when the unitrust percentage is low. Further, the strategy cannot be funded with S corporation stock: It would negate the corporation's subchapter S election. Funding a CRUT with illiquid

assets, like closely held business interests, commercial real estate, or works of art, poses unique challenges,<sup>[19]</sup> including the potential for unrelated business taxable income (UBTI). And there is mortality risk: If the client dies shortly after the creation of the CRUT, charity would disproportionately benefit. Deferring income taxation into the future may cause the owner to pay tax at higher marginal federal and state rates; the same may be said for deferred compensation arrangements and qualified plans. Other factors that may affect suitability of a CRUT include the grantor's (1) income tax basis in the asset being transferred to the CRUT; (2) age and health; and (3) potential for future relocation to a lower- or higher-tax-rate state. A client with a very long investment horizon who doesn't need immediate access to the contributed capital stands to benefit most from deferral using a CRUT. All of these risks must be identified and assessed by the client's tax and investment advisory teams before implementing a CRUT.

Importantly, changes to the Section 7520 rate have very little effect on the maximum permissible payout of a CRUT; higher rates allow for a very slightly higher unitrust payout. If a CRUT would have made sense in 2020 or 2021, when interest rates were at historic lows, it should still make sense today. With the right set of facts, a CRUT can be an important tax planning strategy for clients who are selling appreciated assets and seek to defer substantial gains. In many cases, the cumulative economic benefit of deferring capital gain tax over one's lifetime greatly exceeds the benefit payable to charity upon the grantor's death. Thus, given the right circumstances, a CRUT may work better as a personal wealth strategy than as a charitable strategy.

### **3. Private Placement Life Insurance (PPLI)**

#### **a. The High-Return, High-Tax Conundrum**

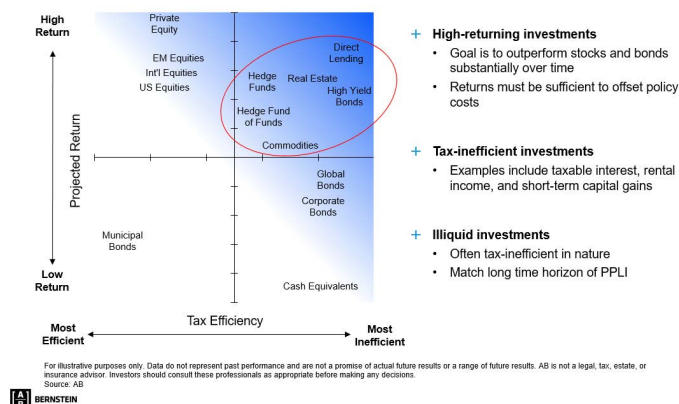
Properly structured life insurance potentially offers unique income tax benefits, including tax-free growth during the insured's lifetime and a full step-up in basis at death, even if the insured does not then own the policy. Given these benefits, qualified purchasers and accredited investors should consider investing in certain high-returning, tax-inefficient "alternatives" through low-cost PPLI, rather than owning those asset classes directly. Rising interest rates may impact the policy's underlying investment portfolio, but those rates affect PPLI as a strategy only if the purchaser (1) borrows from a third-party lender to finance the premiums or (2) is a multigenerational trust that relies, in whole or in part, on loans from the grantor to finance premiums.

As discussed previously, both stocks and bonds are unlikely to enjoy the kinds of returns in the future that we have seen in the recent past. It's possible to achieve 10% or greater returns in certain segments of the fixed income and stock markets, but often, these alternative strategies produce nothing but current income that is taxable at the highest marginal rates. Lower expected returns, the reemergence of inflation, and stiff income tax consequences on some of the most potentially productive investments—this perfect storm of circumstances creates challenges that investors haven't seen in quite a while.

#### **b. The Case for PPLI**

One potential solution to this dilemma is to concentrate high-returning, tax-inefficient investments in one's tax-deferred qualified retirement plan or individual retirement account (IRA). But many investors don't have adequate funds set aside in those kinds of accounts to take full advantage of their tax-deferred nature. For those investors, it may be useful to package high-returning, tax-inefficient investments in a portfolio that can be accessed through a low-cost PPLI policy. When properly structured, growth of assets held in a PPLI policy will not be subject to current income taxation. If held until the insured's death, the policy's death benefit is almost always income-tax-free to the beneficiary.<sup>[20]</sup> And if policy premiums are paid gradually (generally, in at least three roughly equal installments) rather than immediately, cash value may be accessed during the insured's lifetime without incurring income tax. The types of high-returning, tax-inefficient alternative investment strategies that are likely to benefit most from PPLI range from hedge funds and real estate to direct lending and high-yield bonds (**Display 5**).

Display 5: Asset Classes Best Suited to PPLI



Short-term capital gain and ordinary income is currently taxed at federal rates as high as 37%; if categorized as “net investment income,” there may be an additional 3.8% federal surtax.<sup>[21]</sup> The investor’s tax domicile may impose an additional income tax at the state and local levels. In certain jurisdictions, the combined tax rate on this type of income can exceed 50%. If the investor doesn’t have sufficient capacity in a qualified plan or IRA, a 10% pretax annual return in these alternative investment strategies may produce an after-tax return of less than 5%—for some, not worth the trouble.

But what if instead we could invest in those same alternative strategies through PPLI? In that case, if the policy is properly structured, no current income tax would be paid, but the investment portfolio would bear annual insurance expenses. In most cases, those expenses should be less than 1% per year—0.70% annual expenses<sup>[22]</sup> over the long term are typical for a well-designed policy on a healthy insured. If that expense estimate is accurate, then in this example, the investor’s 5% after-tax annual return outside of PPLI becomes a 9.3% after-expense return in the PPLI policy. Over the course of a single generation, PPLI can produce after-tax portfolio values and death benefits that are 2.5 to four times higher than had been comparable investments made through a taxable account.

Why not just use “normal” life insurance to accomplish the same thing? Retail variable life insurance products generally provide access only to registered funds—the kinds of traditional stock and bond portfolios that are expected to struggle over the next 10 years. In contrast, PPLI can offer unregistered funds, potentially including alternative investment strategies that may be capable of double-digit pre-tax annual returns. Moreover, expenses associated with traditional life insurance products generally (but not always) are much higher than those associated with PPLI. This combination of higher expected returns and lower expenses makes PPLI particularly appealing, especially in the current challenging investment environment. Because PPLI is treated as an unregistered “private placement” investment for securities law purposes, only those who are qualified purchasers and accredited investors within the meaning of those laws may purchase a PPLI policy.

**c. The Opposite of Life Insurance?**

Importantly, PPLI is real life insurance; income tax deferral benefits are forfeited if the policy does not comply with various insurance regulations and tax requirements. But PPLI serves a very different purpose than traditional life insurance. In the traditional model, the objective is to pay the lowest possible premiums in exchange for the greatest possible death benefit, because a traditional policy is a hedge against early death. *PPLI is the opposite*: The twin objectives in PPLI are to (1) invest the *most* premium dollars as quickly as possible and (2) acquire the *least* additional incremental death benefit that the tax laws will allow. At any point in time, the spread between the cash value of the investment portfolio and the policy’s death benefit is referred to as the “net amount at risk” (NAR), which is the portion of the death benefit for which the insurance company is responsible upon the death of the insured. The greater the NAR, the more the insurance carrier will charge against the cash value of the policy to compensate itself for the risk that the insured may die during the next year. As the insured ages, the cost of insurance per unit of risk increases substantially. By reducing NAR to the lowest possible level, PPLI policy expenses are kept at an absolute minimum. Low expenses reduce the drag on performance of the PPLI’s investment portfolio, thereby giving that portfolio the greatest opportunity to grow in value free of income taxes. Unlike traditional life insurance, PPLI is a bet on the insured’s *longevity*, not a hedge against mortality.

Arguably, the best prospective PPLI purchaser is a multi-generational trust. This tentative conclusion is driven largely by the current challenging investment environment. In the past, the trustee of a multigenerational trust typically has been advised to invest trust assets in a traditional, stock-tilted portfolio; 80% stocks and 20% bonds was a common recommendation. But based upon our 10-year return projections, such an 80/20 portfolio is likely to compound at a rate of just about 5% per year, pretax, over that period, compared to a historical annual return of more than 9% for that asset mix. Going forward, inflation is likely to consume about 2.5% of annual return, and income taxes another 1% or so, leaving perhaps 1.5%, on average, available for distribution. If annual, after-tax distributions to current beneficiaries are expected

to exceed 1.5% of portfolio value, the result is likely to be a *negative* real return for assets retained in trust for later distribution to remainder beneficiaries. That result could be a disaster, especially if the trustee is subject to the duty of impartiality, which requires a trustee to treat all beneficiaries—current and remainder—fairly and equitably. Modifying the traditional asset allocation advice to (1) include alternatives and (2) “package” the tax-inefficient portion of those alternatives in PPLI has the potential to reverse the outcome described in the foregoing example.

What if, instead of a multigenerational trust, our client or prospective client is a 50-year-old entrepreneur who has just sold her business? Assume that she has never been able to set aside much in a qualified plan or IRA, but she is very interested in having future returns on her portfolio avoid unnecessary income tax drag. Further assume that she would like to start taking withdrawals to help finance her retirement starting at age 65. PPLI structured as a non-modified endowment contract (non-MEC) may be a perfect solution. If she were to fund a PPLI policy in three annual premium installments of \$1 million each and the policy’s diversified alternative investment portfolio were able to achieve compound annual growth of 10% before policy expenses, a healthy entrepreneur may have cash value of more than \$10.5 million available for retirement income starting at age 65. If the policy were a properly structured non-MEC, the entrepreneur’s first \$3 million of withdrawals would be treated as tax-free return of premium, and she could borrow the remaining \$7.5 million at an interest-rate spread guaranteed never to exceed 0.50%–0.70%,<sup>[23]</sup> depending upon the insurance carrier she selects.

#### d. Structural Oddities

PPLI would be especially powerful if investors could simply pick and choose policy investments at will from the universe of options that are available in the capital markets. Unfortunately, such customization has the potential to destroy tax deferral—the most important benefit of PPLI. Court cases and IRS rulings have resulted in a series of tax rules that are loosely described as “investor control” restrictions. In a nutshell, these rules require that the insurance carrier, not the policyholder, make all decisions related to the availability and composition of investment portfolios in PPLI. The net effect of these restrictions is that the policyholder generally must choose from a “menu” of portfolio options that various investment managers make available on insurance carriers’ platforms. If a PPLI policyholder can influence the composition of the portfolios in which he can invest, that policyholder runs the risk of losing deferral of current taxation of portfolio income.<sup>[24]</sup> Bottom line: Customization is possible but potentially hazardous. The safer strategy is to choose from among the portfolios that insurance carriers make available for investment through PPLI.

In addition to these investor control restrictions, the underlying investments in every variable life insurance policy must be adequately diversified within the meaning of Code Section 817(h).<sup>[25]</sup> Most policyholders invest in PPLI through one or more so-called “insurance-dedicated funds” (IDFs), but it’s also possible for an investment manager to assemble a diversified collection of non-IDFs as a separately managed account (SMA). There are three primary reasons why an investor might prefer an SMA to an IDF: (1) better pricing (no third-party administration fee); (2) separate account investments are not disrupted by the liquidity needs of other policyholders; and (3) reporting—although limited to “read-only” access due to investor control restrictions—more closely reflects what most investors are used to seeing for their personal accounts. Disadvantages of SMAs include (1) often higher minimum required premiums; and (2) new premium may need to be “parked” in suboptimal strategies (e.g., a money market fund) pending capital calls by the targeted alternative investment strategies; these delays tend to impede overall performance.

When looking at your first PPLI illustration, one thing will probably jump out: The policy’s death benefit is illustrated to drop precipitously after the first few years. The reason for that is simple. Dropping the death benefit as quickly as allowed under the tax laws reduces the policy’s NAR, which reduces the costs of insurance that the carrier charges to compensate itself for the risk that the insured may die during the next year, which reduces the portfolio’s expense drag. The primary objective of PPLI is not to hedge against an early death; traditional life insurance products generally should be used if that is the primary concern. In PPLI, the goal is to take advantage of the longest possible run of tax-free cash value growth with the lowest expense drag possible on portfolio returns. If a PPLI illustration does *not* show a substantial decrease in the death benefit during the early years of the policy, that is an oversight—which may be attributable to an insurance advisor who does not sufficiently grasp the true power and purpose of PPLI.

Another counterintuitive aspect of PPLI is that the insurance carrier’s credit rating may not matter much. In PPLI and other “variable” life insurance products, the death benefit consists of two components: the policy’s cash value and the NAR. Cash value is segregated in a separate account for the exclusive benefit of policyholders; those assets are not subject to the claims of the insurance carrier’s general creditors, so the carrier’s credit rating has no impact on the cash value component of the death benefit. The insurance carrier is responsible only for the NAR, which in PPLI is intentionally kept extremely low.

### III. Conclusion

Although interest rates have spiked recently, they remain relatively low by historical standards. Nevertheless, capital is no longer virtually free, as it was at times in 2020 and 2021. And future investment returns are likely to pale in comparison to historical returns. As a result, the spread between expected returns and cost of capital is the lowest it’s been in many

years.

Estate planners who employ leveraged strategies, like installment sales to IGTs and GRATs, should do so advisedly, with a primary focus on asset classes that are likely substantially to outperform traditional stocks and bonds. Strategies that do not depend on leverage, such as gifts and valuation discounts, are much more valuable when interest rates rise, and may resurge to the forefront. So may strategies like QPRTs that just work more efficiently in a high-interest-rate environment. Old standbys, like short-term rolling GRATs, CRUTs, and PPLI, should remain relatively unaffected.

Each client's circumstances are unique, so a deep, quantitative, customized analysis by a multidisciplinary team of legal, tax, insurance, valuation, and financial experts is essential. What's worked well in the recent past may not be the right choice today. Clients are depending on us, now more than ever, to make the best decisions on their behalf.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!**

*Thomas J. Pauloski*

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#### **CITATIONS:**

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[1] See Rev. Rul. 2004-64, 200-4-27 C.B. 7 (Jul. 6, 2004).

[2] In 2023, the inflation-indexed "basic exclusion amount" is \$12.92 million. See Rev. Proc. 2022-38, <https://www.irs.gov/pub/irs-drop/rp-22-38.pdf>. In 2024, that amount will increase by \$690,000, to \$13.61 million. See Rev. Proc. 2023-34, <https://www.irs.gov/pub/irs-drop/rp-23-34.pdf>.

[3] Of course, everything felt risky in 2022, when investors in US large cap stocks lost 18.3% and investors in intermediate-term Treasuries lost 10.6%. So far, 2023 has been considerably better, on both fronts.

[4] In fact, due to TCJA's permanent adoption of "chained inflation" as the approved method for indexing various exclusions, credits, brackets, and other items, the basic exclusion amount in 2026 (after sunset) is likely to be *lower* than it would have been had TCJA never been enacted. "The chained CPI-U ... generally increases at a slower rate than the traditional CPI-U, implying that individuals will end up in higher tax brackets and that indexed tax credits (like the earned income tax credit) will increase at slower rates than they would have under the old indexing system. The change in indexing is permanent." Tax Policy Institute, "How Did the Tax Cuts and Jobs Act Change Personal Taxes?" <https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-personal-taxes>.

[5] The Office of the Chief Counsel recently determined that a business owner's attempt to transfer closely held stock to a GRAT failed because the grantor's valuation of the transferred shares was stale and did not account for a pending merger of the company. Chief Couns. Adv. 202152018 (Oct. 4, 2021), <https://www.irs.gov/pub/irs-wd/202152018.pdf>. In effect, the IRS said to the taxpayer, "I don't know what you have here, but it isn't a GRAT." And if it isn't a GRAT within the meaning of Code Section 2702, then it's a gift—which may result in payment of gift tax if the grantor does not have sufficient applicable exclusion to cover the fair market value of the transferred assets. Although some may question the reasoning of this CCA, it has had a chilling—and perhaps salutary—effect on what some viewed as a proliferation of reflexive overreliance by business owners and their professional advisors on outdated valuation information, often calculated without the benefit of a qualified, independent appraiser.



[6] See Matthew J. Madsen, “Financing a CLAT with a Note Can Accelerate the Transfer of Wealth to Heirs,” 30 Est. Plan. 495 (Oct. 2003). In our 2012 study, the probability of a positive remainder in the highest quartile of Section 7520 rates increased from 51% with no discount to 85% when funding the T-CLAT with a note that reflected a 25% valuation discount.

[7] See *supra* note 2.

[8] There is some speculation that the Treasury Department may attempt to curtail the use of valuation discounts by regulation at some future date, though nothing concrete has materialized. Nevertheless, this bears watching.

[9] In addition, “[i]n the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for [life] if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before . . . age 110.” Treas. Reg. § 20.7520-3(b)(2)(i). Failure of this exhaustion test may result in deemed gift of portion of assets initially transferred. See, e.g., Treas. Reg. § 25.7520-3(b)(2)(v) Example 5.

[10] See, e.g., Milford B. Hatcher, Jr., “Preferred Partnerships, The Neglected Freeze Vehicle,” 35-3 Univ. of Miami Law Center on Est. Planning (Jan. 2001), <https://rappslaw.com/wp-content/uploads/2015/03/HatcherPaper1.pdf>; see also Rev. Rul. 2023-2, <https://www.irs.gov/pub/irs-drop/rr-23-02.pdf>.

[11] Assume that the portfolio is rebalanced continuously to represent the actual composition of the index. The difference between “owning the index” and “owning the stocks”? The stock portfolio benefits from the dividends paid by the constituent companies; the index does not.

[12] In a 2016 study, Bernstein back-tested how effective a series of two-year, rolling GRATs would have been if implemented in rolling 10-year periods commencing in 1956, which corresponds to the beginning of the last multidecade period of rising interest rates. In that study, rolling GRATs would have delivered a positive remainder in each such 10-year period, whether interest rates rose or fell during that decade. Single, 10-year GRATs implemented during those same periods would have been significantly less reliable. See Bernstein Private Wealth Management, “The Path from GRAT to Great: Efficient Wealth Transfer with Grantor Retained Annuity Trusts” (2016), at 11-12, [https://www.bernstein.com/Bernstein/EN\\_US/Research/Publications/Instrumentation/PathFromGRATtoGreat.pdf](https://www.bernstein.com/Bernstein/EN_US/Research/Publications/Instrumentation/PathFromGRATtoGreat.pdf).

[13] These seemingly favorable circumstances can backfire in the rare case when there is an intervening noncharitable interest for someone other than the grantor’s surviving spouse (e.g., to grantor for life, *then to child for life*, then to charity). In such a case, the government’s tables tend to overvalue the *intervening* interest because it will begin sooner under the government’s tables than is likely in reality, resulting in a higher gift tax value than the interest actually is worth. For this reason, it is generally inadvisable to create intervening noncharitable interests for anyone other than the grantor’s surviving spouse, if any. Other strategies more efficiently transfer wealth to younger generations.

[14] See I.R.C. § 664(d)(2)(D).

[15] Although the government’s actuarial assumptions also produce the collateral benefit of a larger income tax charitable deduction, that deduction is not a primary driver of a CRUT’s success. Of the three factors that maximize personal wealth derived from a CRUT—upfront income tax deduction, longevity of the grantor, and tax deferral—the deduction is, by far, the least important.

[16] If the remainder beneficiary were, or could be, a private foundation, her deduction would be limited to a fraction of her adjusted basis in, rather than the fair market value of, her company stock.

[17] To qualify for the income tax charitable deduction, the transferors’ interest in their closely held stock cannot have “ripened from an interest in a viable corporation into a fixed right to receive cash.” See *Ferguson v. Comm’r*, 174 F.3d 997 (9<sup>th</sup> Cir. 1999).

[18] See Bernstein Private Wealth Management, “Income Tax Saving Strategies for Business Owners” (2023), at 9-11, <https://www.bernstein.com/content/dam/bernstein/us/en/pdf/whitepaper/IncomeTaxSavingStrategiesforBusinessOwners.pdf>.

[19] See Paul S. Lee & Stephen S. Schilling, “CRTs Are Back (in Four Delicious Flavors),” *Trs. & Ests.* (Oct. 2014), at 31.

[20] See *generally* I.R.C. § 101. Certain “transfers for value” during the insured’s lifetime may cause the imposition of income tax on the excess of the policy’s death benefit over the sum of consideration and subsequent premiums paid by the transferee. See I.R.C. § 101(a)(2).

[21] For individuals, trusts, and estates, the highest marginal federal brackets are 37% for ordinary income and 20% for long-term capital gain income. See I.R.C. § 1(a)-(e), (h). For passive “net investment income” in excess of specified thresholds, an additional 3.8% federal surtax applies. See I.R.C. § 1411(a)(1).

[22] PPLI annual expenses usually include a mortality and expense (M&E) charge of 0.35%–0.55% per year, plus costs of insurance (COIs) that usually amount to 0.10%–0.40% (expressed as a percentage of policy cash value) per year for a healthy insured, and a nominal policy administration fee. In addition, a third-party administration charge may apply to an investment that is structured as an insurance-dedicated fund (IDF).

[23] This “interest-rate spread” is the difference between (1) the interest rate charged by the carrier on the policy loan and (2) the fixed rate credited to the policyholder on the collateral component of the policy’s cash value. When the loan is repaid, the collateral is reinvested in the policy’s segregated account.

[24] For an egregious example of this type of policyholder behavior, see *Webber v. Commissioner*, 144 T.C. 324 (2015).

[25] See Treas. Reg. § 1.817-5. Specifically, an insurance carrier’s segregated asset account cannot invest more than 55% of the total account value in any one investment, more than 70% in any two investments, more than 80% in any three investments, or more than 90% in any four investments. See Treas. Reg. § 1.817-5(b)(1)(i). Generally, a carrier’s segregated asset accounts are tested for compliance with these diversification requirements on the last day of each calendar quarter. See Treas. Reg. § 1.817-5(c)(1). For purposes of the percentage limitations, an “investment” generally means any interest in a partnership, trust, or other entity, provided that in the case of a so-called “insurance-dedicated fund” or IDF (i.e., a fund that is available for investment exclusively through the purchase of a variable life insurance policy or annuity contract), diversification is tested by “looking through” the entity to the underlying investments of the fund. See Treas. Reg. § 1.817-5(f).

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Consult with competent professionals in these areas before making any decisions.

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