Planning in Uncertain Times Part II: The Cost of Delay (Gift)

An article by Bob Finnegan, J.D., CLU®, HCB Senior Vice President, Advanced Sales Attorney

"With all of the uncertainty surrounding the future of the transfer tax system, many clients will consider delaying planning because it seems like a prudent course. It is important however that they understand the substantial cost of delay in terms of wealth transferred to the family. This analysis utilizes a financial model to evaluate and understand these costs. It looks at a few possible, and arguably likely, repeal scenarios based on a set of reasonable assumptions as to the future. There are three essential takeaways from this analysis and from the prior newsletter (Estate Planning Newsletter #2492 (December 20, 2016)):

1. The cost of delaying planning measured by the amount of wealth transferred to the clients' family at life expectancy is substantial and dramatic.

2. It is essential that clients and advisors understand this cost of delay as well as take into account the many non-tax reasons for planning in order to make an informed decision whether or not to plan currently.

3. Due to the uncertainty around future transfer tax laws, it is important to consider flexible planning strategies and trust arrangements and site trusts in states with favorable decanting and other laws."

Robert W. Finnegan, J.D., CLU®, is the estate planning attorney for Highland Capital Brokerage where he specializes in business, estate, charitable and life insurance planning, with an emphasis on planning for the ultra-high net worth client. He has been published in a number of national trade magazines including Estate Planning, Probate and Property and the Journal of the American Society of CLU® and ChFC®, and spoken at numerous industry meetings. Throughout his career, he has designed and utilized financial models to evaluate and compare complex transactions, including gift/sales to dynasty trusts (typically intentionally defective grantor trusts) and the impact of life insurance on the overall planning results.

Bob can be reached at 518.424.8928 or at bfinnegan@highland.com.

HIGHLAND
CAPITAL BROKERAGE

Here is his commentary:

EXECUTIVE SUMMARY:

Part I of this Newsletter reviewed i) President Elect Trump's legislative agenda, ii) how Mr. Trump's plan and the GOP Blueprint for tax reform address repeal, iii) the legislative hurdles to repeal and iv) the likely (or unlikely) "permanence" of any legislation.

With all of the uncertainty surrounding the future of the transfer tax system, many clients will consider delaying planning because it seems like a prudent course. It is important however that they understand the substantial cost of delay in terms of wealth transferred to the family. This analysis utilizes a financial model to evaluate and understand these costs. It looks at a few possible, and arguably likely, repeal scenarios based on a set of reasonable assumptions as to the future. There are three essential takeaways from this analysis and from the prior newsletter (Estate Planning Newsletter #2492 (December 20, 2016)):

1. The cost of delaying planning measured by the amount of wealth transferred to the clients' family at life expectancy is substantial and dramatic.

2. It is essential that clients and advisors understand this cost of delay as well as take into account the many non-tax reasons for planning in order to make an informed decision whether or not to plan currently.

3. Due to the uncertainty around future transfer tax laws, it is important to consider flexible planning strategies and trust arrangements and site trusts in states with favorable decanting and other laws.

COMMENTARY:

This newsletter provides a quantitative analysis of the cost of delaying planning based on a specific set of assumptions. As a mental exercise, it is virtually impossible to assess the complex interaction of the many tax, economic and other factors and interactions. A modelling approach can help us understand how these various factors can affect a family's financial security over time.

The Model and Model Assumptions

This analysis is based on a financial model designed to simulate the future. Much of the value of a simulation model is the ability to compare various scenarios under different sets of assumptions. This analysis will focus on the wealth transferred via a dynasty trust as well as the grantors' estate at the assumed joint life expectancy of age 90/year 31 (LE) based on the following core assumptions[1]:

• Husband and wife are each age 60 and in good health.

• Clients have $10M gift and GST exemptions available for planning[2].

• The model carves out and evaluates $15M of assets from their estate.

• Assets grow at a 5% pre-tax return and a 4% after-tax return (20% annual tax on earnings).

• Upon the second death, assets will be subject to a 40% estate tax (federal only).

In order to evaluate the cost of delaying planning, assumptions are also made regarding future transfer tax laws. First, the model projects the benefits of implementing a discounted gift to a dynasty trust today (I. below). It compares the wealth transferred to the family with and without planning. Next the model examines the cost of delaying planning (II. below) by assuming that it is delayed for five or ten years (i.e. planning takes place in the beginning of years six and 11). Moving forward from the assumed planning date, the model assumes that the transfer tax structure in place today is back or has remained in place (assuming that the gift and GST exemptions, available discounts and long term AFRs are i) the same as today or ii) less favorable). This could happen because of one of the following:

- Repeal never takes place.
- Repeal is only for ten years and then automatically reverts to current law (as a result of the reconciliation process and the inability to produce spending cuts that offset revenue deficits due to tax reform).
- The gift tax is not repealed, leaving the whole transfer tax system in place, making reinstatement to our current system more likely.
- Repeal is "permanent", but Democrats re-instate the transfer tax structure as it stands today.

The Benefit of Planning Under the Current Transfer Tax System

Before examining the cost of delay, it is important to first establish a baseline by evaluating the benefit of gifting today assuming the gift, estate, GST and income tax laws remain as they are today indefinitely.

I. **The Chart compares the net to family upon the second death in any given year for the following two scenarios:**

   A. No planning. Clients invest the $15M and earn 4% after-tax. Upon the second death, the accumulated value is included in the estate, offset by the available $10M estate & GST tax exemptions.

   B. Gift $15M of assets, discounted by 33 1/3rd%, for a net gift of $10M to a dynasty trust that is also a defective grantor trust. Trust assets earn 5% pre-tax and taxes are paid by the grantor so that the estate is reduced by the "tax burn" equal to the trust income taxes and loss of the use of those funds.
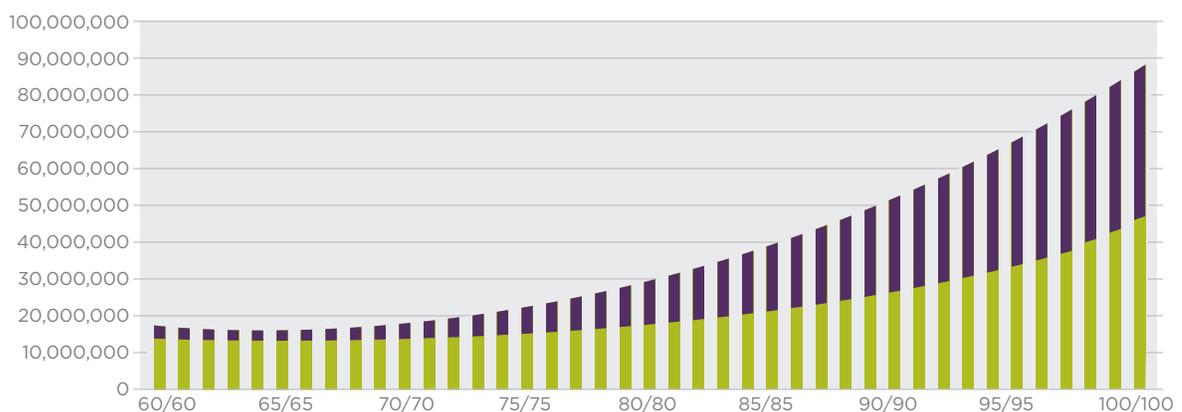
The chart makes it clear that the gift takes times to transfer substantial wealth because it is only transferring the appreciation and the discounted value. At life expectancy (age 90) the gift to the dynasty trust today results in $23.2M more to the family and, more importantly, it has transferred $58M more into a dynasty trust while reducing the amount the children would have received in the No Planning scenario by **($34.8M)**.[3]

HIGHLAND CAPITAL BROKERAGE

TABLE I: PLANNING TODAY NET TO FAMILY AT LE (AGE 90)

GST Exempt Character	Plan Today Scenarios		Improvement
	A. No Planning	B. Gift (No LI)	B - A
Exempt	10,000,000	68,070,592	58,070,592
Non-Exempt	24,358,201	(10,484,155)[4]	(34,842,355)
Total	34,358,201	57,586,438	23,228,237

The Cost of Delay

In order to evaluate the cost of delay, the model projects the net to family at clients' joint life expectancy (age 90, year 31) and compares Plan Today to Plan in 5-Years or Plan in 10-Years under the following three scenarios:

    A. The gift, estate and GST exemptions remain at $10M; a 33 1/3rd% discount is still reasonable; and the AFR remains at 2.75% (the January 2017 Long Term AFR). Plan with $15M (appreciation from today until the planning date is accounted for as an asset of the estate).

    B. Same assumptions as A, except that in the Plan in 5-Years and Plan in 10-Years scenarios, plan with $15M plus appreciation from today until the planning date.

    C. The gift, estate and GST exemptions have been reduced to $7M[5], a 20% discount is allowed, the AFR has increased to 3.75%[6] and plan with $15M plus appreciation from today until the planning date.

II. Gift $15M ($10M Exemption).

    A. Same Assumptions as Plan Today. Clients delay planning for ten years because they thought that repeal would become permanent. In fact, repeal sunsets, reverting to the law as it stood in 2017. At that point clients are each 10-years older, but all planning factors have remained the same (1/3rd discount, $10M gift and GST exemption available[7], 5% pre-tax growth, 4% after-tax growth).

TABLE IIA: NET TO FAMILY AT LE (AGE 90)

Plan Today: $15M Gift ($10M Net), 1/3rd Discount
Plan in 5-Years: $15M Gift ($10M Net), 1/3rd Discount
Plan in 10-Years: $15M Gift ($10M Net), 1/3rd Discount

Transferred From	Plan Today	Plan in 5-Years	Plan in 10-Years	Cost of Delay: Plan Today vs. 10 yrs.
Dynasty Trust	68,070,592	53,335,090	41,789,439	26,281,154
Estate	(10,484,155)	(1,642,853)[8]	5,284,537[8]	(15,768,692)
Total	57,586,438	51,692,237	47,073,976	10,512,461

By planning today substantial additional wealth is shifted from the taxable estate to the dynasty trust due to:

- The appreciation of the gifted discounted assets in dynasty trust and
- Income taxes on trust income paid by the grantor and the cost of money due to the loss of the use of those funds.

Continues >

HIGHLAND
CAPITAL BROKERAGE

B. However, $15M in five or ten years is worth substantially more than today. Based on the assumed 4% after-tax growth rate, $15M would grow to $18.25M in five years and $22.2M in ten years. Table IIB reflects the same assumptions as A. above, but assumes that the clients are willing to plan with those greater amounts. The additional amounts above $15M ($3.25M in 5-years, and $7.2M in 10-years) are sold to the trust (at an assumed 2.75% January 2017 Long Term AFR), since the available $10M gift and GST tax exemption[7] would only shelter the basic $15M gift at a 1/3rd discount.To summarize:

Table IIB: Net to Family at LE (Age 90)

Plan Today with $15.00M: $15M Gift ($10M Net), 1/3rd Discount
Plan in 5-Years with $18.25M: $15M Gift ($10M Net), $3.25M Sale ($2.17M Net), 2.75% LT AFR, 1/3rd Discount
Plan in 10-Years with $22.20M: $15M Gift ($10M Net), $7.20M Sale ($4.80M Net), 2.75% LT AFR, 1/3rd Discount

Transferred From	Plan Today	Plan in 5-Years	Plan in 10-Years	Cost of Delay: Plan Today vs. 10 yrs.
Dynasty Trust	68,070,592	59,346,875	51,603,814	16,466,778
Estate	(10,484,155)	(5,249,924)[9]	(604,088)[9]	(9,880,067)
Total	57,586,438	54,096,951	50,999,726	6,586,711

C. But how realistic is it to assume that in five or ten years all assumptions have remained as favorable as they are today? Consider the following alternative scenario:

1. In year five or ten, the combined gift and GST tax exemption is $7M (vs. $10M).
2. The Long Term AFR has increased to 3.75% (vs. 2.26%, December 2016).
3. The available discount has decreased from 33.33% to 20%.
4. As a result of the lower exemptions and reduced discount, the client can only gift $8.75M ($7M/(1-20%)), and will sell the balance in a discounted note for

    a. Plan in 5-Years: $9.50M = $18.25M-$8.75M x (1-20%) = $7.6M
    b. Plan in 10-Years: $13.45M = $22.20M-$8.75M x (1-20%) = $10.76M

Table IIC: Net to Family at LE (Age 90)

Plan Today with $15.00M: $15M Gift ($10M Net), 1/3rd Discount
Plan in 5-Years with $18.25M: $ 8.75M Gift ($7M Net), $ 9.50M Sale ($7.6M Net), 3.75% LT AFR, 20% Discount
Plan in 10-Years with $22.20M: $ 8.75M Gift ($7M Net), $13.45M Sale ($10.76M Net), 3.75% LT AFR, 20% Discount

Transferred From	Plan Today	Plan in 5-Years	Plan in 10-Years	Cost of Delay: Plan Today vs. 10 yrs.
Dynasty Trust	68,070,592	42,077,272	35,763,895	32,306,697
Estate	(10,484,155)	5,111,837[10]	8,899,863[10]	(19,384,018)
Total	57,586,438	47,189,110	44,663,759	12,922,679

HIGHLAND
CAPITAL BROKERAGE

Estate planning tends not to be our clients favorite pastime. Although tax efficiency (Plan Today versus in the future) should not be the tail that wags the dog, many clients will decide not to plan because, on a superficial level, inaction may seem like a prudent course. In making that decision, it is important that clients understand the impermanence of any repeal, the cost of delaying planning, the ability to implement highly flexible planning strategies and the many essential non-tax reasons for planning.

Note: In Part III of this newsletter, we will introduce survivorship life insurance into the model, (insuring the lives of our 60-year old clients), comparing Plan Today (and purchasing the life insurance today) to Plan in 5 or 10-Years. Even assuming that the clients are still insurable at preferred non-tobacco rates, the costs of delay are even greater because purchasing insurance when the insureds are five or ten years:

1. The premiums are substantially higher.
2. The $15M subject assets cannot support as much insurance.

CITATIONS:

1. The model also makes the following assumptions:

    a. Based on the gifted assets, it projects the following for every year up to age 100:

        i.   The Dynasty Trust cash flow and total value.
        ii. Grantor's cash flow due to the "tax burn" and the effect on the grantor's estate.
        iii. The net to family upon the second death in any given year.

    b. The dynasty trust is a defective grantor trust, i.e. all income taxes are paid by the grantor.

    c. Clients die in the same year so that any estate taxes are deferred until the second death.

    d. Estate assets are assumed to not qualify for a discount.

    e. All numbers in tables are shown at life expectancy (LE, Age 90/Year 31).

    f. The model does not take into account the loss of stepped up basis on $15M of assets gifted or sold to a Dynasty Trust.

        i.   For comparison I, taking this into account would reduce the wealth transferred in the gift scenario. A fair market value swap of cash or note prior to death would be possible so that the gifted assets would obtain a stepped up basis.
        ii. For comparison II, all scenarios (Plan Today, Plan in 5-Years, Plan in 10-Years) preserve the original $15M, so that taking into account taxation of the built in gain would be a "wash" across all scenarios.

2. For 2017, the federal gift and estate tax exemptions are $5.49M ($10.98M for married couples). In order to simplify calculations, it is assumed that the clients have $10M of exemptions available.

3. The examples in this analysis demonstrate the benefit of "wealth shifting". By reducing the net to children after estate taxes, the pre0tax amounts amounts have been shifted without gift, estate or GST taxes into a dynasty trust that will escape transfer taxation indefinitely. It is important to remember that the $15M subject assets represent only a portion of the clients' estate and, in most cases, children will still receive substantial wealth through the estate.

HIGHLAND
CAPITAL BROKERAGE

CITATIONS (cont.)

4. The **($10,484,155)** and all negative estate values represent the "tax burn" at life expectancy (age 90/ year 31). The tax burn has two components: a) the income taxes paid by the grantor, and b) the loss of the use of those funds (the cost of money). Compounding the loss of the use of those funds (i.e. compounding a negative number) and the corresponding reduction of the taxable estate can be counterintuitive. If the grantor had a $100M estate in addition to the $15M of gifted assets, those estate assets would grow at a compound 4% after-tax return. If the grantor pays $100,000 of trust income taxes, the earnings of the estate are reduced from $400,000 to $300,000. The estate would lose the future growth (or "use") of those funds at the 4% after tax return. In addition, the taxable estate would be reduced by the $100,000 plus the future cost of money on those funds. What may seem confusing is that the model does not start with $100M, but rather begins with $0, so that the effect of the grantor paying taxes produces a negative number that is more apparent.

5. Under the alternate less favorable assumptions, the exemption is assumed to decrease from $10M to $7M, reflecting the Secretary of State Clinton's recent campaign proposal.

6. For years 2007-2011, The Long Term AFR equaled or exceeded 3.75% for 47 (out of 60) months. Since 2012, the Long Term AFR has remained below 3.75%. The average Long Term AFR for 2007-2016 is 3.70%.

7. The model ignores any increases in the gift and GST exemptions between now and the delayed planning dates. At the delayed dates, those increases would be available to the Plan Today as well as the Plan in 5 or 10-years, in effect a "wash".

For Notes 8-10 below:
Based on the assumed 4% after-tax growth rate, $15M would grow to $18.25M in 5-years and $22.2M in 10-years. This appreciation must be taken into account in the delayed planning scenarios II. A-C, either as an asset of the estate, or as a transferred asset (via a sale).

8. In scenario II.A., it is assumed that the clients are only willing to gift $15M. The difference of $3.25M ($18.25M - $15M) in Plan in 5-Years and $7.2M ($22.2M - $15M)in Plan in 10-Years, is an estate asset that reduces the "tax burn".

9. In scenario II.B., retaining our current planning environment, it is assumed that the clients are willing to plan with the appreciated value of $18.25M (Plan in 5-Years) and $22.2M (Plan in 10-Years). The difference is sold to the trust so that the note payments back to the estate reduce the "tax burn".

    a. The assumed sales are as follows:

        i. $3.25M ($18.25M - $15M) discounted by 1/3rd to $2.167M (Plan in 5-Years)
        ii. $7.2M ($22.2M - $15M) discounted by 1/3rd to $4.8M (Plan in 10-Years)

    b. Note is assumed to be interest only (2.75%) with a

        i.   Balloon payment in year 20 (Plan in 5-Years) or
        ii. Balloon payment in year 15 (Plan in 10-Years).

10. In scenario II.C., with a less favorable planning environment, it is assumed that the clients are willing to plan with the appreciated value of $18.25M in 5-years and $22.2M in 10-years. However, since we have assumed a lower combined exemption ($7M vs. $10M) lower discount (20% vs 33 1/3rd%), the clients can only gift $8.75M. The note payments (plus the growth of those note payments) offsets the tax burn.

    a. The assumed sales are as follows:

        i. $9.50M ($18.25M - $8.75M gift) discounted by 20% to $7.6M (Plan in 5-Years).
        ii. $13.45M ($22.2M - $8.75M gift) discounted by 20% to $10.76M (Plan in 10-Years)

    b. Note is assumed to be interest only (3.75%) with a

        i.   Balloon payment in year 20 (Plan in 5-Years).
        ii. Balloon payment in year 15 (Plan in 10-Years).

HIGHLAND
CAPITAL BROKERAGE