“Leaning into Social Distancing: A Perfect Storm for Wealth Transfer” Background:

Although the capital markets have recovered somewhat March 2020 lows, there are still many undervalued assets and asset classes that may be ideal candidates for wealth transfer. In addition, yields on Treasury securities, which drive many estate planning strategies, are at or near all-time lows. Of these two factors-market valuation and interest rates-valuation is, by far, the more important, whether the transfer strategy is a gift, GRAT, or installment sale to an "intentionally defective" grantor trust.

For many clients, the time to act is now. In the current environment, an illiquid asset, such as an interest in a closely held business, may be valued at a substantial discount from its ultimate liquidation value; those discounts are likely to persist for the foreseeable future. On the other hand, readily marketable assets, such as publicly traded stocks, may be subject to significant upward and downward swings in value due to volatility; the urgency of a sale or other wealth transfer strategy may be heightened for such assets. A transfer to a grantor trust may be advisable in this environment, as it gives the grantor the opportunity to "swap" assets with the greatest prospects for future growth into the trust, without income tax consequence, in exchange for less "growthy" assets, and to change that mix from time to time as circumstances warrant.

Wealth transfer opportunities:

Today's market conditions may provide the best wealth transfer opportunity since March 2009- for those families who are bold enough to act. Strategies that have particular appeal include the following:

.               GRAT or installment sale to an irrevocable grantor trust: Bernstein research shows that short-term, "rolling" GRATs work well irrespective of the market climate, although longer- term GRATs and installment sales of assets other than marketable stocks have a much greater chance for success when both valuations and interest rates are low. Could future tax legislation effectively eliminate the rolling GRAT strategy, as early as 2021, by either increasing the minimum annuity term or eliminating the ability to "zero-out" a GRAT?

.               GRAT immunization: Immunizing a GRAT-swapping cash or bonds for stocks held in an existing GRAT-provides the grantor with an opportunity to start over. Bernstein research shows that when a GRAT is underwater by at least 10%, immunization is likely to produce a better result than "weathering the storm" for the rest of the annuity term. Immunization is not for everyone-it adds complexity, both for the family and the portfolio manager-but can produce superior results when carefully implemented and monitored.

.               Value-shifting: Arguably, the most provocative opportunity in the current wealth transfer environment is the long-term applicable federal rate (AFR), which is 1.12% in August 2020, and may fall below 1% for the first time ever in September. The ability to lock in a rate that low for 15, 20, or even 30 years is profoundly game-changing: The longer a portfolio's time horizon, the more likely it will beat an interest-rate "hurdle." Based on results from Bernstein's wealth forecasting model, virtually every asset class, including cash, should soundly outperform a 1% annual interest-rate hurdle over the next 30 years. Clients can take advantage of the extraordinarily low long-term AFR to shift wealth over time from a “bad" place (e.g., a wealthy individual's balance sheet or a trust that is "nonexempt" for generation-skipping transfer (GST) tax purposes) to a much better place (e.g., a GST-exempt dynasty trust). This type of value-shifting is very difficult or impossible to replicate in a normal interest-rate environment.

.               Roth conversion: With valuations low for many asset classes, individual compensation income for 2020 potentially threatened, and the possibility of an increase in individual

income tax rates looming on the horizon, now might be an ideal time to convert a traditional individual retirement account (IRA) to a Roth IRA. A Roth conversion requires a participant to pay ordinary income tax on the fair market value of assets transferred from the traditional account to the Roth account. Current account balances may be low, reducing the tax base upon which the tax cost of conversion must be computed. For an executive whose bonus may be much lower in 2020 than in 2019, the effective tax rate to convert from traditional IRA to Roth IRA may be very low as well.

.               Refinancing intrafamily debt: In recent years, many families have used sales or loans at the prevailing AFR to transfer future growth of portfolios to family members or to trusts for their benefit. The extraordinarily low current AFRs may provide an excellent opportunity to refinance such debt. For example, a Bernstein client lent millions of dollars to an irrevocable grantor trust for nine years at the August 2012 mid-term AFR of 0.88%; that note will mature in August 2021. Our client plans to refinance part of that debt for nine years at the mid-term AFR (0.41% in August 2020) and part for 20 years at the long-term AFR (1.12% in August 2020). When refinancing, most professionals will require the borrower to give up something-perhaps a modest payment down of principal-to get the benefit of a lower rate, but is a paydown of principal required? What else might constitute adequate consideration?

Conclusion:

Valuations are low for certain assets and asset classes, interest rates are at or near long-term lows, and adverse tax law changes are looming on the horizon. For these reasons, now is an extraordinary time to talk to clients about wealth transfer planning.