Triangulation: Integrating Life Insurance into the Estate and Investment Plans

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Introduction

There is something about life insurance that cannot be disputed: If someone were to purchase a life insurance policy this morning and then be hit by a bus while crossing the street this afternoon, no other investment—stock, bond, hedge fund, or otherwise—would be able to produce the internal rate of return for the individual's family over the brief period of its existence than that policy would provide.[1] On the other hand, if the insured were to live 50 more years, there may be no *worse* investment for the individual's family than that policy. Somewhere between three hours and 50 years, there is a "crossover point" at which life insurance ceases to be an optimal investment.

This grim reality—that life insurance migrates from being a spectacular investment, to a mediocre investment, to a downright miserable one, depending on how long the insured lives—is the key to understanding the true power of life insurance, and why it should be used *in almost every case* to complement estate and investment planning. Lifetime wealth transfer planning can produce incredible results, but the benefits may take years to manifest.[2] Similarly, sound investment planning usually produces excellent long-term results, but returns over short time horizons are much less certain. Life insurance complements long-term estate and investment planning because it pays off immediately in the event of an untimely death. Think of it this way: Life insurance provides a large benefit if the insured dies in the near-term; estate and investment planning "insure" the financial benefit to the family over the long haul. For this reason alone, life insurance may be thought of as the ideal hedge to a sound estate and investment plan.

One might be tempted to make an all-or-nothing "bet" on longevity if financial analysis were to suggest that avoiding payment of life insurance premiums and investing exclusively in a capital market portfolio is more likely to produce greater absolute, long-term returns. Recent mortality data in the United States—especially for high-net-worth individuals—supports this conclusion, at least superficially.[3] But the choice between life insurance and the capital markets is not a binary decision; some of each is advisable in almost every case. Even investment managers must concede that risk-adjusted, rather than absolute, return

ought to be the prime objective for most investors. Few investors put every penny into stocks due to volatility; adding doses of bonds and alternative investments like hedge funds help make returns smoother and more predictable over time. Both stock and bond returns are vulnerable to inflationary cycles; assets like commodities, inflation-protected securities, and real estate can hedge that risk. But there is one risk that no stock, bond, or alternative investment can hedge: The risk of a family member's sooner-than-expected death. Such an early death might cut off the income stream provided by a breadwinner, result in additional living expenses for the survivors, or accelerate the imposition of estate tax. Life insurance, if used properly, can hedge these risks, often at a startlingly low relative cost.

But in our experience, life insurance is rarely sold in a way that accurately assesses its risk-adjusted return potential when used in combination with a well-structured estate and investment plan. Done right, insurance has the power to direct more after-tax wealth to beneficiaries *at a time in their lives when they may need it most*—without creating a long-term drain on a family's portfolio or precipitously depleting current cash flow.

With this article, we hope to start nothing less than a revolution in the way insurance producers sell, and tax professionals and investment managers think about, life insurance. Here are the tenets that we hope to prove—or at least forcefully advocate—in this article:

- DON'T base the amount of death benefit to be purchased on rules of thumb, such as "10 times after-tax earnings."
- DON'T determine the appropriate amount of life insurance premiums solely upon the number of annual exclusion gifts available to a family.
- DON'T base the amount of death benefit entirely upon on the amount of estate tax that would be payable if the insured were to die today, because that amount may vary dramatically over time with market volatility, changes in spending patterns, tax law changes, changes of domicile, and a host of other—often unpredictable—factors.
- DON'T limit life insurance to those cases where the senior generation holds illiquid assets that may not be sold prior to death; based upon our assessment of risk-adjusted return, even *fully liquid* families should have some life insurance.[4]

- DO use life insurance to hedge against estate *and income* tax issues that may arise as the result of an untimely death.
- DO use life insurance to supplement liquidity, especially in cases where some estate tax is likely to be payable, a substantial portion of the estate is illiquid, the illiquid assets are unlikely to be sold during the senior generation's lifetime, and the estate may not qualify for deferral under Section 6166[5] of the Internal Revenue Code (Code) or for a *Graegin*[6]-type loan under Internal Revenue Service (IRS) guidelines.
- DO integrate the insurance, estate, and investment plans, rather than "silo-izing" those three components of a client's plan; a team approach to planning is vital in the current environment.
- DO base the amount of death benefit on a sound assessment of the expected *needs* of the intended beneficiaries; their lifetime financial needs are likely to be greater when they are *younger*; as they grow older, their expected time horizon shortens and they are likely to need *less* accumulated capital to support their lifestyle.

- DO recognize that the true power of life insurance is its ability, in the case of an early death, to deliver more capital to beneficiaries when they are relatively young and likely to need that capital most.
- DO recognize that the benefits of estate and investment planning take time to manifest, and that life insurance may be thought of as a "bridge" that buys the time needed to allow that planning to blossom fully.
- DO use investment and estate planning to reduce the *duration* of life insurance coverage; it's the duration of coverage, not the amount of death benefit acquired, that tends to make insurance expensive, and sound lifetime estate and investment planning can reduce that cost dramatically by shortening duration.
- DO use low-cost private placement life insurance (PPLI) when investing in diversified, high-returning, tax-inefficient portfolios.

How the 2012 and 2017 Tax Acts Changed the Face of Estate Planning—and Life Insurance

For decades, life insurance has been marketed and sold to high-net-worth families based upon a questionable premise: That the death benefit of the policy being sold should equal the anticipated amount of estate tax that will be owed upon the death of the insured, or upon the second death in the case of a married couple. Alternatively, the insurance advisor may show the maximum amount of death benefit that can be acquired by aggregating the annual exclusion gifts that are available after taking into account all of the clients' descendants—and sometimes their respective spouses.[7] In many insurance proposals, both of these "objectives" are achieved—leaving one to wonder whether, in a given case, the entire proposal was contrived to reach a predetermined outcome that has nothing to do with the family's needs.

Allowing the tax cart to drive the horse (i.e., basing the death benefit solely upon the amount of estate tax that will be owed in the event of immediate death or upon the number of gift tax annual exclusions that happen to be available at that moment) makes no more sense in life insurance planning than it does in estate or investment planning. Sure taxes are important. But like estate and investment planning, the life insurance plan should be *goal-driven*, based primarily upon the *needs of the intended beneficiaries*, not driven exclusively by tax considerations, which may be ephemeral. And when possible, all three elements—insurance, estate, and investment planning—should be *integrated* into a cohesive whole.

Changes brought about by the American Taxpayer Relief Act of 2012 (ATRA) and "the-legislation-formerly-known-as the Tax Cuts and Jobs Act of 2017" (TCJA)[8] provide an ideal opportunity to take a fresh look at life insurance. ATRA changed the face of estate planning considerably. For example, the basic exclusion amount that each person may shelter from federal gift and estate tax was scheduled to revert to a fixed $1 million effective January 1, 2013. Instead, ATRA retained the $5 million inflation-indexed exclusion; TCJA "doubled-down" on that amount through 2025. Today, the basic exclusion stands at $11.4 million per person, $22.8 million for a married couple.[9] As a result, it is estimated that about one in 1,500 families currently have enough wealth to need transfer-tax-driven estate planning.[10] If estate taxes are likely to affect only those few, what should the other 1,499 families do? We

believe that life insurance is just as relevant to planning for those other families as it is to the one family in 1,500 that may have an estate tax liability.

These developments have forced estate planning professionals to re-think how they advise their clients. There are many reasons for this shift. First and foremost, very few families now need plans that are driven exclusively by reduction or elimination of the estate tax, which should allow most plans to be based upon family needs and goals, rather than by the Code. But it's not always clear on which side of the line a particular family may fall. For example, there are couples who currently have considerably less than the combined basic exclusion amount of $22.4 million who absolutely should do tax-driven estate planning because it's likely, based upon our assessment of potential estate growth, that they will pay some estate tax at the second death if they don't plan. On the other hand, there are others with estates exceeding $22.4 million today who are likely to "spend their way out" of their estate tax problem during their lifetimes.[11] In addition to the pending "sunset" of the current basic exclusion amount after 2025, the key drivers are time horizon, projected return on investment, and future spending coupled with inflation. An insurance plan that is based solely upon the estate tax consequences of an immediate death and the number of annual exclusion gifts that a family can make seems woefully short-sighted in a post-ATRA, post-TCJA world.

SIDEBAR: LIFETIME WEALTH TRANSFER CASE STUDY

If a family is likely to face estate tax, should the parents embark on a lifetime wealth transfer strategy? The answer to this question—and every other estate planning question—is: "It depends."

For example, assume that mom owns $2 million of a publicly traded stock that has an income tax basis of zero. Further assume that she doesn't need the stock or the dividends it produces, so she'd like to give that stock to her daughter as a lifetime gift. Finally, assume that mom lives in a state that has no state-level death tax,[12] but that her daughter lives in California, where she "enjoys" the highest marginal state income tax rate in the country—13.3 percent.[13]

The benefit of a lifetime gift is that all *future* appreciation in the value of the stock will avoid a 40 percent estate tax. But we also know that with a lifetime gift, the donee "inherits" the donor's income tax basis in the stock,[14] which in this case is zero. Under this set of circumstances, mom would be transferring to her daughter an asset that has a built-in income tax liability of as much as $732,000; at the highest marginal bracket, the blended federal and California long-term capital gain tax rate is 36.6 percent, taking into account the deduction for state income taxes paid on net investment income.[15] And the transfer tax laws give a donor no "credit" in the form of a valuation discount for that built-in income tax liability. In other words, the transfer tax laws treat a lifetime transfer of $2 million of cash exactly the same as a transfer of $2 million of stock that is subject to a $732,000 tax liability.[16] Under these circumstances, is a gift of appreciated stock from mom to daughter a good idea?

Well, if mom were to die tomorrow without having made this gift, her estate would receive a step-up in basis and her daughter could receive the stock through her mom's testamentary estate plan with no hidden income tax liability.[17] But if mom made the gift today and she were to die tomorrow, her daughter would pay a lot of additional income tax due to the loss of the basis step-up—if and when she sells the stock. In either case, the estate tax outcome would be substantially the same,[18] but the income tax result would be vastly different in these two cases.

Here's the key: When someone wants to transfer an appreciated asset to a family member (or to any person or entity other than a charity), there is a built-in income tax liability that has to be "burned off"—in the form of an offsetting transfer tax benefit—before the donee can realize a financial windfall.[19] And the transfer tax benefit of a lifetime gift takes time to manifest. The key drivers include the donor's time horizon, the "tax gap"—that is, the difference between the *donor's* estate tax rate and the *donee's* effective income tax rate—, the donor's basis, and the asset's prospects for future growth. Keep in mind that the tax gap depends on multiple factors, including the tax domiciles of the donor and donee, the donee's expected income tax bracket at the time of sale, whether the subject matter of the gift is a capital asset or something else, and many other circumstances.

Note, too, that a proper assessment of this problem is not based upon estate tax consequences alone; both estate *and income* tax consequences of lifetime wealth transfer strategies must be taken into account. In this particular example, life insurance, if employed, would be used primarily to hedge the *income*-tax risk of the lifetime gift—that is, the potential loss of a step-up in basis sooner than expected as a result of the donor's early death. As noted previously, there is a $732,000 built-in capital gain tax associated with the appreciated stock in this example. Given enough time, post-transfer appreciation in the value of that asset will create sufficient transfer tax savings to overcome the initial income tax headwind and the loss of a basis step-up on future growth. If mom were to die too soon, however, that transfer tax benefit will not have had time to blossom. To hedge that mortality risk, mom could make the initial stock gift to a trust *and* provide additional funding—perhaps using annual exclusion gifts—that would allow the trustee to acquire a life insurance policy having an initial face amount of $732,000. If a universal life (UL) insurance policy were used for this purpose, the death benefit of that policy gradually could be reduced[20] as the transfer tax benefit of the strategy overcame the income tax hurdles. Importantly, this type of integrated tax and insurance planning is no longer just theoretical; we are using this methodology today with clients and their professional advisors, as we shall discuss later in this article.

Historically, most planners have viewed life insurance exclusively as an estate tax hedge, not as a way to mitigate income tax exposure. ATRA and TCJA provide an opportunity to change that mindset.

Even families who are prodigious spenders may have an estate tax problem now; for them, strategies like grantor retained annuity trusts (GRATs)[21] can work well. Hedging GRAT mortality risk with term life insurance (or insurance that acts much like term, such as UL

with a secondary no-lapse guarantee) is advisable in many such cases. And when dealing with a married couple whose marriage is very secure, having one spouse make the other a permissible beneficiary of an inter vivos irrevocable trust—a so-called spousal lifetime access trust (SLAT)[22]—can be an attractive option. This strategy, paired with an insurance policy on the life of the beneficiary spouse held in a *separate* irrevocable life insurance trust (ILIT) of which the grantor of the SLAT is a permissible beneficiary, can provide continuing access to wealth that otherwise would be cut off by the untimely death of the spousal beneficiary of the SLAT.[23] There is no single or easy answer for these families; flexibility is the key, and life insurance can help enhance that flexibility.

Aside from today's unexpectedly high basic exclusion amount, another factor that has evolved is the relatively greater importance of income tax planning. Until ATRA came along, we all thought that estate tax rates were going to revert back to 55 percent. But that didn't happen; under ATRA, the federal transfer tax rate settled at 40 percent—still quite high, but not as bad as it could have been. At the same time, the federal long-term capital gain tax rate is as high as 23.8 percent for passive investments.[24] The income tax rate is even higher than that for collectibles, and higher still for short-term capital gains and ordinary income. And some states, like California, New York, and Minnesota, among others, have very high income tax rates on top of those higher federal rates. As a result of all this, the "gap" between transfer tax and income tax rates has closed considerably for many families. In some odd cases—like when families own, say, depreciated real estate[25]—the cost to the family of losing a step-up in basis at death actually may be greater than if mom had simply kept the asset on her balance sheet, paid the estate tax, and gotten a basis step-up. Sometimes, the best gift that a parent can make to her children may be no gift at all.

ATRA also made portability of the applicable exclusion amount a permanent feature of the federal tax law. Portability is the notion that for a married couple, the applicable exclusion of the first spouse to die may be "ported" over to the survivor by making an election on the deceased spouse's federal estate tax return.[26] As a result, a couple in a common law jurisdiction may not need to split up assets and adopt an estate plan that creates a credit shelter trust upon the death of the first spouse to die. Instead, the estate plan can provide that each spouse will leave all of his or her assets to the survivor, and the executor of the first spouse to die can elect to port that spouse's applicable exclusion to the survivor. When the dust settles after the first death, the surviving spouse has all of the couple's assets and a combined exclusion of as much as $22.4 million. Aside from simplicity, one benefit of this method is that the entire estate will get a step-up in basis at the second death. That may be much more difficult to achieve in an estate plan that calls for a credit shelter trust to be established at the first death. And portability seems ideally suited to situations where the first spouse to die has substantial assets in a qualified retirement plan or individual retirement account. Before portability, couples faced a real dilemma: Whether to leave such benefits outright to the surviving spouse and get potentially great income tax treatment but no estate tax relief at the second death, or to leave those assets in a credit shelter trust to avoid estate taxes but with potentially lousy income tax treatment due to acceleration of required minimum distributions.[27] With portability, leaving qualified plan benefits to a surviving spouse provides the best available income tax treatment and enhances the survivor's ability to shelter those assets from estate tax at the second death.

Portability is helpful, but it's not perfect. For one, the portability election must be made on a federal estate tax return,[28] regardless of the possibility that the value of the estate of the first spouse to die may be well below the filing threshold for Form 706—and there is no such thing as "Form 706-EZ." Further, while the surviving spouse's applicable exclusion is indexed for inflation, the deceased spousal unused exclusion (DSUE) amount,[29] is not. As a result, the longer the surviving spouse sits on the DSUE, the less purchasing power that DSUE will have upon her death. And only the applicable exclusion is portable; the GST exemption for federal generation-skipping transfer tax purposes is not. While it's possible to do GST tax planning with portability, it's messy and inefficient.[30]

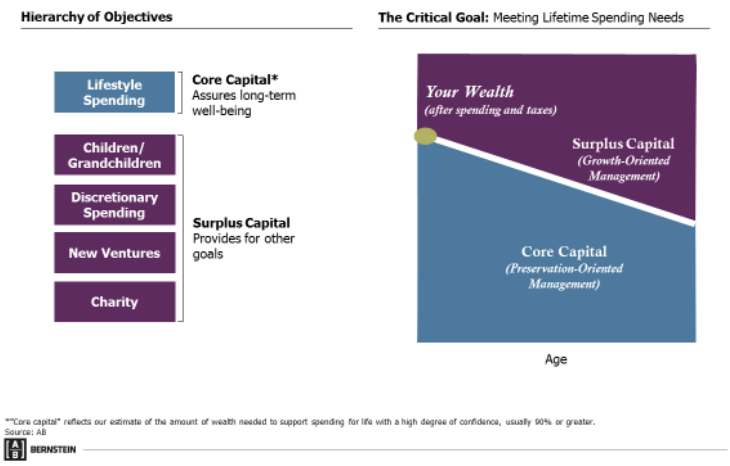
We live in a complicated world, and ATRA and TCJA have only added to that complexity. The questions that clients face are not always easy to answer. Are they actually going to avoid estate tax? Is a step-up in basis likely to be more valuable to the family than avoidance of estate tax? What role will state income and death taxes play in the overall plan? How much does future spending matter? And importantly, what role, if any, should life insurance play? As a result of this complexity, it's important for all of the key advisors—the estate planning attorney, CPA, investment advisors, insurance professional, valuation experts, and others—to talk about these issues openly and get on the same page by developing an *integrated* plan. The life insurance component of that plan should be based upon a much more rigorous analysis than "How much estate tax would the family pay if the insured were to die today?" or "How many annual exclusions are available to offset the premiums required to support this policy?"

The Starting Point: Core Capital

In today's world, it's unrealistic to expect most investors to accumulate a portfolio that will allow them simply to "live off the income." In the current environment, a $1 million portfolio that consists of 60 percent stocks (represented by the S&P 500) and 40 percent bonds (represented by 10-year Treasuries) yields pre-tax income of about $20,000 per year.[31] In 1982, that same portfolio would have generated over $88,000 of pre-tax income. Furthermore, dividend yields and bond interest tend to vary quite a bit over time, so living off the income just doesn't produce reliable enough cash flow for most people. Based on current yields, a retiree who expects to spend $100,000 per year after tax may need a nest egg of well over $6 million to generate sufficient after-tax portfolio income (i.e., dividends and interest) to meet expenses. Some of us may be fortunate enough to be able to save that much prior to retirement, but for many, that's an unrealistic goal.

In our wealth planning framework, we advise clients to set aside a minimum amount for spending that we call "core capital." That amount, allocated prudently, will allow them to spend what they need to spend each year, adjusted for inflation, for the rest of their lives with a very high level of confidence—say 90 or 95 percent—that they will never run out of money.

Display 1: Core Capital



Core capital is represented visually by the downward-sloping white line on the right-hand side of Display 1. This downward slope indicates that the amount of inflation-adjusted capital needed to support lifetime spending will decline over time due to shorter remaining life expectancy as one ages. By way of example, using our methodology, a 65-year-old couple that spends an inflation-adjusted $100,000 per year, after tax, from their portfolio would need $3.1 million today to support that spending for their joint lives with a 90 percent level of confidence. If they decided to spend 30 percent more, or $130,000, each year, their core capital requirement correspondingly would increase by 30 percent, to just over $4 million. An investor's actual spending goal may be more complicated than a fixed, inflation-adjusted annual amount; in those cases, a more rigorous analysis is required to define core capital.

SIDEBAR: WEALTH FORECASTING AND CORE CAPITAL

Many investment firms and certified financial planners (CFPs) use wealth forecasting software to assess potential future outcomes of the capital markets. In this article, all mathematical planning scenarios were tested using Bernstein's proprietary Wealth Forecasting System™ (WFS). This software simulates 10,000 plausible future paths of returns for each asset class and produces a probability distribution of outcomes. Market forecasts are based on the building blocks of returns, such as inflation, yields, yield spreads, stock earnings, and price multiples. The WFS incorporates the linkages that exist among the returns of various asset classes and takes into account prevailing market conditions at the time of the analysis. In addition, a reasonable degree of randomness and unpredictability is factored in. The WFS generates 10,000 new market paths for each analysis; market paths are not "recycled." Importantly, the WFS does not draw randomly from a set of historical returns. History informs, but does not control, the results reflected in the model.

An assessment of a client's core capital requirement is based primarily upon three variables: (1) how much risk the investor is willing to take; (2) how old they are; and (3) how much they want to spend each year, which we typically index for inflation.[32] Armed with an investor's asset allocation, time horizon, and spending, the WFS can arrive at a core capital amount that will support the investor for the rest of their life in 9,000 or 9,500 of 10,000 capital market trials.

Is a 90 or 95 percent confidence level good enough? The short answer is that it tends to be sufficient when there is an opportunity to re-analyze the client's situation periodically, which provides an ability to recommend adjustments to asset allocation and spending when necessary. One problem with solving for a higher level of confidence—say 98 percent—is that the recommended core capital amount at that level is probably going to be much larger than it ultimately needs to be. One wants to be conservative, but also realistic in terms of how much more the investor needs to save in order to ensure a secure financial future. Striking the proper balance between conservatism and realism is indeed a big challenge.

Core capital is designed to be a "sinking fund." Each year, the investor will spend the after-tax income of the fund, and to the extent that income is insufficient, some principal. The objective is to make that fund big enough so that it won't run out of money even if the investor lives a very long time or experiences periods of high inflation, or if the capital markets perform poorly. For the vast majority of investors, this conservative approach is very effective—it gives them peace of mind that they will be secure.

Of the three variables upon which we base our core capital computations—asset allocation, longevity, and spending—spending may be the most important. It's a variable that an investor can control, and it has a significant and quantifiable impact on the core capital amount. On the other hand, longevity is by far the most underappreciated variable. Recent actuarial data[33] shows that for a typical 65-year-old couple in the US, there is a 50/50 chance that at least one of them will live to age 92, and a one-in-four chance that at least one of them will live to age 97. High-net-worth Americans tend to live six to eight years longer than that.[34] Thus, a retirement portfolio for a high-net-worth, 65-year-old couple conservatively may need to last 35 years or more, which implies for most asset allocations an annual spending rate of barely three percent in the first year, indexed for inflation thereafter, based upon projected market conditions—well below the often-cited four percent "safe" spending level upon which many retirees have been told they can rely. A well-designed portfolio needs to be customized to the clients' circumstances, and must be able to survive poor markets, inflation, and a potentially long time horizon.

Mind the Gap: Using Life Insurance to Fund Core Capital

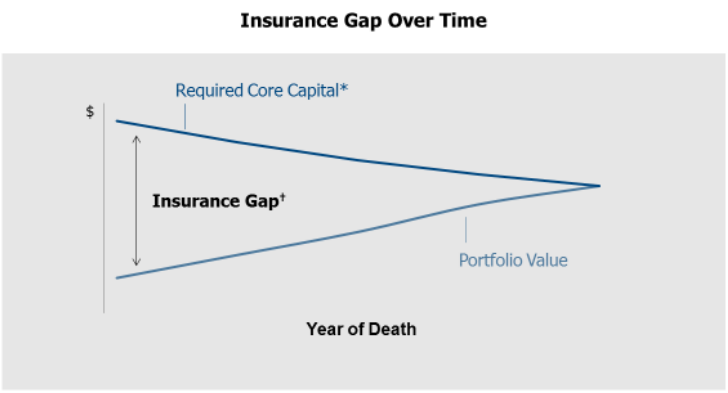
For many working investors, core capital is what we might refer to euphemistically as an "aspirational portfolio"; they're not quite there yet, but if they continue to earn what they hope and expect to earn for the foreseeable future, they should be able to reach their core portfolio requirement with a high level of confidence prior to retirement. In other words, they are on a trajectory for success—but two things could change that trajectory. First, the

family breadwinner could lose his or her job—and there's no financial product that can hedge against that possibility. Second, the breadwinner could die, and in that case, life insurance could be used to make up for lost income. But how much insurance should one acquire and maintain to fill that need? The amount of death benefit recommended in a case like this typically is determined by applying a rule of thumb—for example, an oft-quoted benchmark is 10 times after-tax earnings. That may seem reasonable, but is it a good solution in a given case?

The problem with a rule-of-thumb solution like this one is that its effectiveness tends to vary greatly depending upon when the breadwinner dies. For example, if the breadwinner were to die in the near-term, well before retirement, the rule-of-thumb death benefit, added to the family's portfolio, might fall well short of the 90 percent level of confidence that we consider minimally acceptable within our core capital framework. On the other hand, if the breadwinner were to die much later—shortly before he would have retired, say—the rule-of-thumb death benefit may provide substantially *more* than is necessary to fund core spending.

In cases like these, rather than follow a rough guideline based on *income*, we use our wealth forecasting model to define the amount of death benefit that the family may *need* at any point in time to fund core capital. In this framework, the amount of death benefit required equals the difference, measured over time, between (1) the amount of core capital that the family is likely to need based upon spending; and (2) the projected future value of their portfolio, which we usually solve at a 90 percent or greater level of confidence—in other words, assuming that future capital market returns are much lower than expected. At any given point in time, the spread between those two amounts reflects what we describe as the "insurance gap," as illustrated in Display 2.

Display 2: Target Death Benefit Should Be Based Upon Survivors' Need, Not Lost Income



*"Core Capital" is the amount of wealth required to support the surviving spouse's lifetime spending at a 90% or greater level of confidence. The fact that the line declines over time in this illustration is not to suggest that individuals spend less as they get older; rather, their remaining life expectancy decreases, so less wealth is needed to sustain inflation-adjusted spending for life.
†"Insurance Gap" is the amount of death benefit needed to supplement the portfolio and provide the required core capital amount.
Source: AB
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Once we conclude our financial analysis, we provide the insurance gap display to the family's insurance advisor, who in turn uses it to create a customized insurance plan designed to fill that gap. Notably, the result of that analysis has nothing to do with a rule-of-thumb death benefit amount that is related to current income. Instead, it is the result of an

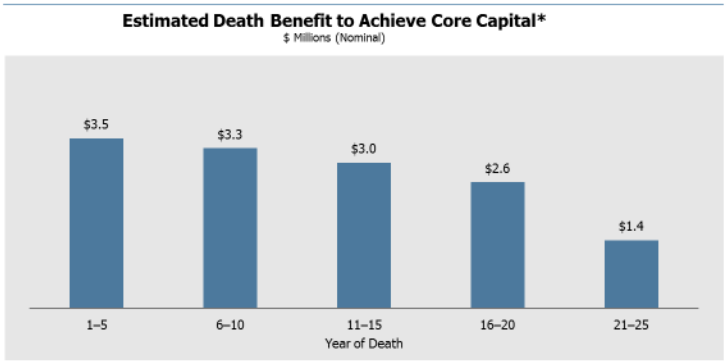
integrated analysis that is based upon our most conservative capital market projections and the spending-driven *needs* of the client at any given point in time.

SIDEBAR: INSURANCE GAP ANALYSIS CASE STUDY

For example, consider Steve and Edie, a married couple, ages 42 and 39, respectively, with two young children. So far, they have saved about $300,000 in their retirement accounts, invested in a moderate asset allocation. Steve currently earns $247,000 per year and expects his salary to grow with inflation. While working, he will contribute the maximum amount to his company's 401(k) plan each year and anticipates a 3 percent employer annual match. With the help of their parents, they have been able to set aside enough to cover their children's college educations. But what would happen if Steve were to die suddenly? How should life insurance be used to hedge this risk? And even if Steve were to survive, are they on track to meet their retirement goals?

To help Steve and Edie answer these questions, we ran a customized analysis and determined that Steve should be able to retire comfortably at age 66 if (1) he continues to maximize his 401(k) plan contributions and (2) annual spending is limited to an inflation-adjusted $100,000 each year. We then illustrated their insurance gap, which as explained previously, is the difference over time between their required core capital and their projected portfolio value.[35] As expected, the longer Steve is able to work and save, the greater their portfolio growth and the less insurance they will need to fill the gap. As shown in Display 3, their insurance gap today is $3.5 million; in 10 years, shrinks to $3 million; and by the time Steve reaches age 66; it closes entirely, meaning that they will have saved enough to support their lifetime spending with a high level of confidence.

Display 3: Often, the Amount of Death Benefit Needed Declines as Investors Age and Their Portfolios Grow



*Represents the total amount of death benefit, in nominal dollars, needed to achieve the core capital required to support the surviving spouse's lifetime annual spending of $100,000, inflation-adjusted, with a 90% level of confidence, assuming median portfolio growth over the next 25 years. Typically, we would model portfolio growth more conservatively in a gap analysis. Note that, among other possible solutions, the required death benefit could take the form of (1) a series of "staggered" term life insurance policies or (2) a single flexible-premium, flexible-death-benefit universal life (UL) policy.
Based on Bernstein's estimates of the range of returns for the applicable capital markets over the applicable period. **Data do not represent past performance and are not a promise of actual future results or a range of future results.** Bernstein does not provide legal, tax, or insurance advice; investors should consult experts in those areas before implementing any insurance strategy.
Source: AB

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Note that, if Steve and Edie had relied upon the 10 times after-tax earnings rule of thumb, they would have fallen well short of required core capital had Steve died in the near term.

Our methodology allows us to customize the analysis and align the life insurance solution with the clients' needs.

With the help of their insurance advisor, Steve and Edie were able to buy a series of term polices that met their needs-based insurance requirement over time. Afterwards, we went back into our wealth forecasting model to assess the effect of the annual premium costs on their portfolio. Usually, those costs are modest for a pre-retirement investor. In this case, the costs of the life insurance hedge (consisting entirely of term insurance in this particular example)[36] had no materially adverse effect on the clients' portfolio. This is exactly what a hedge is supposed to do—protect an investor from risk (in this case, mortality risk) at minimal cost.

In summary, life insurance can provide an inexpensive hedge to protect a core capital portfolio from damage that may be caused by the unexpected, early death of a breadwinner. But the insurance solution needs to be tailored to the investor's individual circumstances. Using rules of thumb based on income to determine the amount of death benefit can be inefficient at best, and at times grossly insufficient. We ask our clients to allow us to determine, on a customized basis, the amount of life insurance that they will need over time to accomplish their goals, and then engage a competent insurance professional to design an insurance plan that will provide the death benefit necessary to accomplish that goal at a fair price. This is "Integration 101"—but we've only gotten started.

How Do I Know Whether My Insurance Policy Is 'Sick' or 'Healthy'?

We frequently are asked to assess a new or existing life insurance plan. Although we are not in the life insurance business, we can examine a series of illustrations, assess whether the assumptions made in each illustration are reasonable, and perform a financial analysis to determine whether investing those premium dollars in something other than the illustrated policy or policies might be better for a particular client. Often, an insurance policy is sold and thereafter never reviewed by the insurance advisor or client. Just as you have performance reviews with your financial advisor, you should have periodic reviews with your insurance agent as well.

We generally assess the investment potential of life insurance using a "crossover" point expressed in years, rather than an internal rate of return expressed as a percentage of assets invested. Crossover, simply defined, means how long the client must live before the insurance policy becomes a less favorable investment than its capital market alternative. If you think about it, this type of crossover analysis is nothing more than expressing internal rate of return in terms of duration—how long a client must live—rather than as an abstract percentage.

We often hear insurance professionals say something like this in meetings: "At your actuarial life expectancy, the internal rate of return on this policy is 5.4 percent. Pretty good, huh?" Frankly, the vast majority of investors have no context to determine whether that return is good or bad. Sure 5.4 percent may sound good, but compared to what? But if, as a

result of our analysis, we are able to tell the client: "On average, this policy is likely to be a good investment if you die within the next 32 years," they readily understand what we are saying. They know when their grandparents died, when their parents died, and when Aunt Betsy died, and they probably have a pretty good idea of when they might die based on family history. We think that the vast majority of clients understand crossover; in our experience, very few understand internal rate of return.

One abuse that we see from time to time is an inappropriate use of actuarial assumptions when assessing the return potential of a policy based upon its expected death benefit. In one particularly egregious case, an insurance analysis that we were asked to review measured life expectancy for a healthy, quite wealthy individual based upon "1980 CSO"—actuarial data that, at the time, was more than 30 years old and did not reflect the insured's accumulated wealth! When an insurance professional is going to cite actuarial life expectancy, the data used should be (1) the most recent available; and (2) appropriate to the gender, wealth, and circumstances of the client. When possible, "longevity risk" should be illustrated; for example, the analysis should highlight the expected outcomes at both median (50^{th} percentile) and possible (say, 85^{th} percentile) life expectancy.

When examining a life insurance proposal, we also need to consider when the policy is illustrated to lapse. A policy's internal rate of return may look exceptionally strong for a period of time, but if that return drops to negative infinity due to a projected lapse, and if that lapse occurs before, or close to, actuarial life expectancy, that may be a strong danger signal that the policy is not suitable for this particular client. As we will show, a planned lapse[37] may not be a bad thing when the life insurance plan is properly integrated with the estate and investment plans. But an unplanned lapse may have disastrous consequences for a family. It's important to pay attention to the crediting rates or return assumptions that the insurance company is using. While the illustration may show the policy continuing until the client's actuarial life expectancy using current rates and expenses, you should ask to see how the policy will perform using less favorable rates as well.

Yet another consideration has come up with increasing frequency lately, especially in connection with UL policies: Is the illustrated lapse date guaranteed or is it based upon "current assumptions"? Many UL policies originated in the 1980s and 1990s, when interest rates were considerably higher than they are today. UL policies that have been in force for a while provide guaranteed minimum annual crediting rates that carriers probably never thought they would see—four percent per year is not uncommon. But as interest rates have continued their steady, multi-decade decline, many UL policies are now crediting at or very near the guaranteed minimum rate. These blocks of policies are supported by investment assets on the carriers' balance sheets—often, large blocks of "laddered" fixed-income securities. As UL carriers replace 30-year debt instruments that had coupon yields of, say, 12 percent with new 30-year obligations that yield less than half that, the four percent crediting rate on UL policies may be unsupportable. What can a carrier do under these circumstances? For several carriers, the answer has been to substantially increase the costs of insurance that they charge on existing UL policies.[38] As a result, even a recent illustration that was based upon the crediting rate and policy expenses *in effect at the time of the illustration* may no longer be worth the paper on which it is printed. This unfortunate

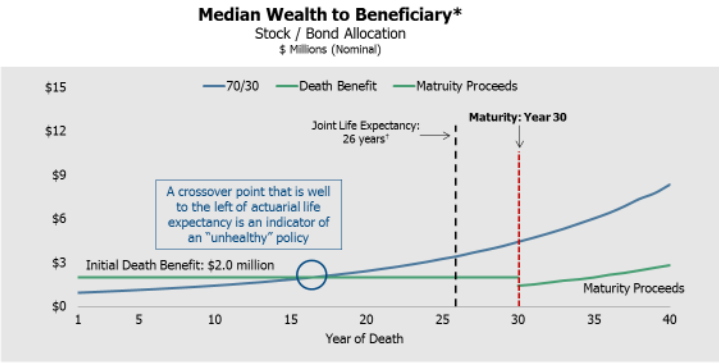
development bears watching; if any potential doubt exists about a particular policy, ask for a new in-force illustration now, and request additional illustrations periodically until bond yields normalize and carriers are able to increase their UL crediting rates.

Although life insurance illustrations can be quite useful, they tend to befuddle clients. Most illustrations are lengthy; an illustration of 14 pages or more is not uncommon. With a few notable exceptions, most illustrations include narratives that are not particularly well written. Tabulated data are extracted from spreadsheets and do not detail how calculations were made. Assumptions generally are not explained and may be unreasonable. Cash value may be illustrated to increase at a pace that greatly exceeds the current crediting rate.[39]And if internal rates of return are provided, that data is expressed as a percentage, which we believe most clients have difficulty processing when that information is provided without appropriate context.

When we assess an insurance illustration, we compare the illustrated death benefit to a tax-equivalent investment in the capital markets. If a new policy is illustrated, we compare the illustrated death benefit to investment of the same planned premiums in a taxable portfolio. If it's an in-force illustration of an existing policy, we assume that the client surrenders the policy, we deduct any applicable surrender charge and income taxes, and we invest the net proceeds, plus illustrated future premiums, in a hypothetical, taxable portfolio, and compare the after-tax value of that portfolio, over time, to the illustrated death benefit. In either case, the asset allocation of that hypothetical portfolio must be appropriate to the client's circumstances—in other words, how would *this client* invest *these funds* if they weren't invested in life insurance.[40] In the case of an elderly policyholder, that hypothetical portfolio may be heavily tilted toward bonds. A younger client's portfolio might be stock tilted. If the policyholder is a trust established for the benefit of descendants who have a long time horizon, that portfolio is likely to be heavily stock tilted.

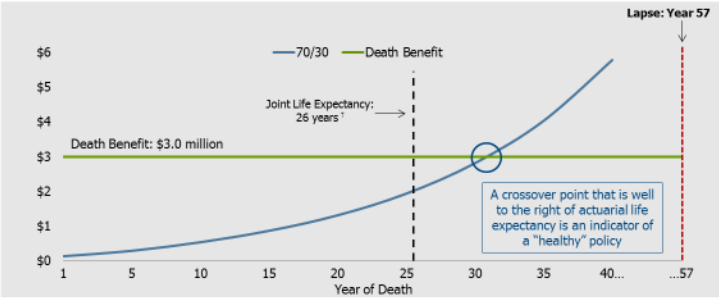
Unlike the multi-page insurance illustration that is the subject matter of our comparative study, the output of our diagnostic analysis is a single-page, graphic display that shows (1) the insured's actuarial life expectancy, (2) the policy's projected lapse date, and (3) our assessment of the median crossover point. Consider the two examples shown in Displays 4 and 5. Note that, for the "sick" policy (Display 4), crossover occurs well to the *left* of the insured's actuarial life expectancy, which means that at the expected date of death, the life insurance policy is likely to provide less wealth than a comparably funded capital market portfolio. In contrast, with the "healthy" policy (Display 5), crossover occurs well to the *right* of actuarial life expectancy. This is what an investor wants: A policy that (1) will not lapse until after life expectancy and (2) is likely to provide the same or more after-tax wealth than a capital market portfolio.

Display 4: What a "Sick" Policy Looks Like



*In this analysis, we compare the policy death benefit to an investment in a taxable capital market portfolio consisting of 70% globally diversified stocks and 30% intermediate-term municipal bonds. Amount invested in this portfolio is the estimated after-tax policy cash surrender value of $900,000. Upon maturity of policy in 2045, policyholder surrenders for cash value; estimated after-tax proceeds of $1,450,000 are invested into a similar taxable capital market portfolio. Portfolios are taxed at top marginal federal income tax rate and a 6.5% state tax rate.
†For a high-net-worth couple, late 60s, nonsmokers, highest underwriting category: 26 years (estimated).
Based on Bernstein's estimates of the range of returns for the applicable capital markets over the applicable period. **Data do not represent past performance and are not a promise of actual future results or a range of future results.** Bernstein does not provide legal, tax, or insurance advice; investors should consult experts in those areas before implementing any insurance strategy.
Source: AB

Display 5: What a "Healthy" Policy Looks Like



*In this analysis, we compare the policy death benefit to an investment in a taxable capital market portfolio consisting of 70% globally diversified stocks and 30% intermediate-term municipal bonds. Amounts invested in this portfolio consist of (i) policy cash surrender value of $100,000 plus (ii) $30,000 per year through 2061 that otherwise would be paid to the insurance company as policy premiums. Portfolio is taxed at top marginal federal income tax rate and a 6.5% state tax rate. Policy cash surrender values and premiums are based on in-force illustration provided by client.
†For a high-net-worth couple, late 60s, nonsmokers, highest underwriting category: 26 years (estimated).
Based on Bernstein's estimates of the range of returns for the applicable capital markets over the applicable period. **Data do not represent past performance and are not a promise of actual future results or a range of future results.** Bernstein does not provide legal, tax, or insurance advice; investors should consult experts in those areas before implementing any insurance strategy.
Source: AB

Importantly, although our diagnostic analysis is based upon a comparison with a taxable capital market portfolio at a particular allocation, it doesn't necessarily follow that the policy actually should be surrendered if we deem that the policy is "sick." Rather, our assessment is merely an indication that *something* should be done about the policy that we have been asked to analyze. In some cases, that may mean an adjustment to the existing policy—for example, decreasing the death benefit of an existing UL policy, but maintaining the same level of funding so that its duration may be extended. In other cases, a Code Section 1035 exchange to a more suitable policy may be the best answer. And still in other cases—rare cases, in our experience—a surrender or sale in the secondary market may be advisable. We use the term "rare" advisedly, because in our experience, (1) many insurance proposals do quite well in our diagnostic analysis; and (2) when we integrate life insurance into the overall estate and investment plan, we often find that our client is *under*-insured, rather than over-insured.

Lastly, the effect of income taxes must be considered. In the hypothetical capital market portfolios that we create as part of our diagnostic analysis, our wealth forecasting software taxes dividends and portfolio gains annually using the insured's actual marginal rates and tax domicile. If a policy is to be surrendered, we tax any gain as ordinary income. This methodology provides an apples-to-apples basis for comparison that, we believe, fairly recognizes the income tax efficiency of life insurance.

Bringing It All Together: The Integration of Insurance, Estate, and Investment Planning

The following example illustrates how life insurance *typically* is integrated into the estate and investment plan: Assume that married clients have a $40 million combined estate. They have their full basic exclusions available, totaling $22.8 million.[41] Thus, slightly more than $17 million of the $40 million will be exposed to estate tax, at an effective rate of 40 percent, assuming no state death tax. The resulting federal estate tax liability would be $6.9 million. Based upon this set of facts, the insurance advisor recommends $6.9 million of joint and survivor life insurance coverage. He further recommends that the couple establish an ILIT for the benefit of their children and younger descendants. The trust is to be drafted so that each descendant (and possibly each spouse of a descendant) will have a temporary right to withdraw annual contributions—a so-called "*Crummey*" power—up to the inflation-indexed limit that the couple can contribute to the ILIT each year without making a taxable gift that would consume some of their $22.8 million combined basic exclusions. To the extent that *Crummey* powers of withdrawal are not exercised by the trust beneficiaries, contributions to the trust will be used to pay policy premiums. The insurance proposal explains that, upon the death of the survivor, the full $40 million estate will pass "free of estate tax" to the descendants; the ILIT proceeds will, in effect, pay the estate tax.[42]

The substantive elements of the foregoing example should sound quite familiar to most estate planning professionals. But the authors believe that this seemingly tried-and-true method of integrating insurance and estate planning is flawed, for several reasons:

- First, it fails to recognize that the insurance solution is temporary; in fact, it is very likely to be out-of-date from the moment it is put in place. That's because the estate's investment portfolio is likely to change (hopefully grow); premium contributions will deplete the couple's estate; there is no accounting in the proposal for income taxes; the couple's applicable exclusions will increase with inflation under current law; tax laws may change; upon the first death, annual exclusion giving capacity will be cut in half; and on and on. Within a few years, this seemingly integrated plan is unlikely to bear any meaningful resemblance to the original objective of paying the entire estate tax liability—which may result in a need to acquire more insurance at a less favorable unit cost.

- Second, the proposal itself is actually *two* proposals. The first proposal is to establish and fund an irrevocable trust for the benefit of descendants; the second is to have the trustee use the contributed funds to purchase a particular life insurance policy or

policies. But does the second proposal necessarily follow from the first? What if the trustee instead invested the contributed funds in a capital market portfolio? Or what if the assets were split between premium payments on a life insurance policy and investment in a portfolio? In the authors' view, the two proposals (gifts in trust, followed by the trustee's investment of those gifts) can and should be evaluated *separately* to fairly assess the merits of each for this particular family.

- But the most important flaw in the way insurance typically is integrated into the estate and investment plans is its failure to recognize that life insurance is the perfect complement to estate and investment planning; its strengths are the others' weaknesses, and vice versa. An integrated plan should embrace these differences and exploit them for our clients' benefit, as we shall explain.

Investment planning is the science of building wealth over time. The better the plan and more disciplined its execution, the greater the long-term effect. But without estate planning, much of that wealth may be lost to taxes—either income taxes during the investor's life or estate tax upon the investor's death.

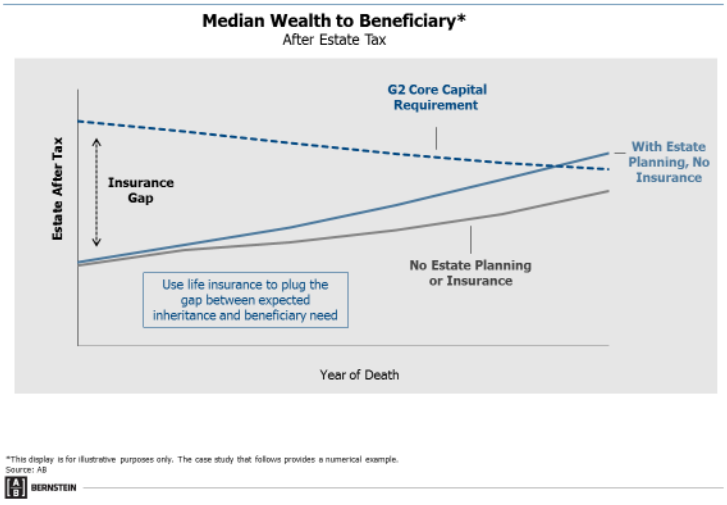
The science of estate planning traditionally has focused on estate tax reduction. Most estate plans accomplish this goal very effectively, but there is a problem: Like a sound investment plan, most estate planning strategies require *time* to manifest because the post-transfer appreciation in value—not the mere transfer of assets— produces the transfer tax benefit.[43] If a transfer by gift or sale is made to an irrevocable ("intentionally defective") grantor trust (IGT), further savings may be realized because the grantor's payment of income taxes on behalf of the trust and its beneficiaries is a gift-tax-free-gift to the trust.[44] But again, the benefit of paying grantor trust income taxes generally takes many years to produce substantial benefits.

As mentioned previously, lifetime transfers of appreciated assets can backfire due to the loss of a potential step-up in basis at death. Depending upon the circumstances, it may take many years to overcome the built-in capital gain tax liability associated with that transferred asset. Alternatively stated, the lifetime transfer of an appreciated asset includes an element of mortality risk. In this context, most insurance proposals assume that the client will keep the appreciated asset, capture the basis step-up, and use the policy death benefit to offset the resulting estate tax liability. Here's a thought: What if, instead, the donor were to *transfer* the asset during life, avoid estate tax on the post-transfer appreciation, forego the step-up, and use life insurance to reimburse the donee for the *income* tax liability that will be incurred when the asset is subsequently disposed of in a taxable transaction? Why is life insurance so frequently brought to bear to hedge the transfer tax risk in the former case, but rarely to hedge the income tax risk inherent in the latter?

The primary reason for this shortfall, we think, is that client advice is often "silo-ized": The estate planner provides her advice; the insurance adviser provides his; the investment managers provide theirs—all without integrating these ideas into a cohesive whole. But when all these advisors cooperate, plans can be harmonized to include consideration of risks that otherwise might have been missed.

Take a step back from all this and view Display 6. The grey line at the bottom of the display represents, in inflation-adjusted dollars, how much the beneficiaries of an estate are likely to inherit over time, net of estate taxes, based on our wealth forecasting model if the family relies solely on investment growth—no estate plan, no insurance plan. Note that the longer the senior generation lives, the more wealth the beneficiaries are likely to receive. The blue line above it represents how much those beneficiaries should receive over time with the same investment plan *plus* a comprehensive lifetime wealth transfer strategy, including grantor trusts—but no insurance. Note that the estate planning ideas add value throughout the process, but that those benefits take considerable time to manifest. One can infer that in terms of raw after-tax wealth, the beneficiaries of young, healthy clients benefit most from the combined power of a sound investment plan coupled with a comprehensive, lifetime wealth transfer strategy.

Display 6: Use Life Insurance to Provide Wealth When Beneficiaries May Need It Most



*This display is for illustrative purposes only. The case study that follows provides a numerical example.
Source: AB
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But there is a problem. The broken line in the upper portion of the display represents our assessment of the inflation-adjusted core capital requirement of the intended estate beneficiaries. Note how the broken core capital line slopes *downward*, while the grey and blue wealth transfer lines, which capture the benefits of estate and investment planning *without* the benefit of life insurance—slope *upward*. This display captures the essence of the problem with an estate and investment plan that does not include a mortality hedge: Raw investment and estate planning, unhedged by life insurance, provides the *least* after-tax amount of wealth to beneficiaries at the time when they need it *most*, and the *most* wealth at the time when they need it least.

The complementary nature of life insurance solves this dilemma. A life insurance death benefit can radically raise the left-hand side of the wealth line up to or near the broken core capital line to protect the beneficiaries' projected wealth in the event of the early death of a parent or parents, at the cost (due to premiums) of gently nudging the right-hand side of that line downward later in life, when the beneficiaries are likely to need the money least.

Expressed alternatively, life insurance hedges the risk of an early death; a well-designed estate and investment plan more than pays for the cost of that hedge.

This, we believe, is the highest and best use of life insurance. The result does not depend upon what the family's potential estate tax liability happens to be at any particular moment in time, or on how many annual exclusions they happen to have available to them at the moment, or on some random number that is stuck in the client's head (e.g., "I want each of my children to get $5 million"—without regard to whether they get that amount tomorrow or in 30 years, when its purchasing power is likely to be considerably diminished). Rather, this truly integrated plan focuses on the core capital needs of succeeding generations of the family. The senior generation merely has to say, "I'd like to finance 50 or 75 or 100 percent of my children's comfortable retirement," and the plan may be integrated to accomplish that result. If the second generation (G2) has sufficient financial security, this same methodology can be used to secure a percentage of lifestyle spending for G3, then G4, and future generations in turn. In our experience to date, those clients who have participated in this planning process find it much more satisfying than the "plug-and-play" insurance plans with which we all have grown accustomed to over the years.

Importantly, when insurance is integrated correctly into a thoughtful estate and investment plan, our experience has shown that (1) the amount of initial death benefit is typically *more* than would have been recommended in a traditional insurance plan, but (2) the duration of that coverage typically is *less*. And it's the *duration* of coverage—not the amount of death benefit—that tends to make life insurance expensive. In long-duration life insurance policies, current premiums often are used to cover more expensive, out-year risks.

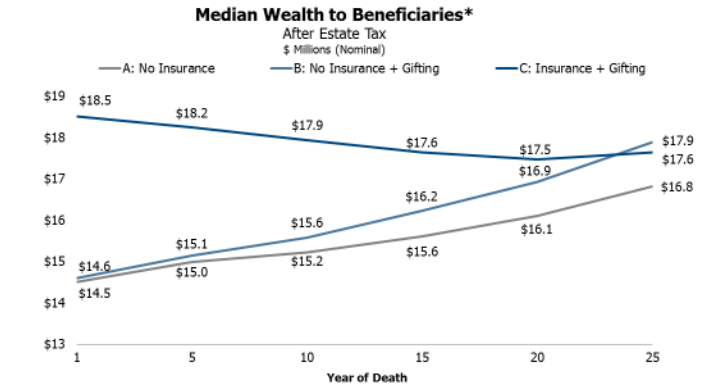
SIDEBAR: INTEGRATED PLANNING CASE STUDY

For example, consider the case of Adam and Eve, a married couple, each 71 years of age, with two adult children and two young grandchildren. Through disciplined saving and prudent investment, Adam and Eve have amassed a $15 million capital market portfolio, half of which is in a taxable account, with the balance divided nearly evenly between a traditional individual retirement account (IRA) and a Roth IRA. Their overall asset allocation is roughly 50 percent globally diversified stocks and 50 percent intermediate-term bonds. With the exception of $300,000 of deferred compensation to be realized over the next three years, almost all of their taxable income each year consists of (1) minimum required distributions from their traditional IRA; and (2) capital gain and dividend income from their taxable portfolio. They reside in a state that imposes a 6.5 percent state income tax, and they expect to spend an inflation-adjusted $300,000 per year.

Many years ago, they established an ILIT to which they make annual contributions of $30,000 to support two life insurance policies having an aggregate death benefit of $5 million, with combined cash value of about $1 million. When acquired, the purpose of these policies was to finance estate taxes. In light of the recent tax law changes, they asked us whether they should maintain these policies—or whether the trustee of the ILIT should surrender either or both of them.

To help Adam and Eve assess their options, we modeled three scenarios. In the first, the trustee of the ILIT would surrender the policies, but the clients would continue to make $30,000 annual gifts to the trust. The trustee, in turn, would invest the surrendered proceeds and annual contributions in a capital market portfolio invested 70 percent in global stocks and 30 percent in intermediate-term municipal bonds—an allocation that reflects the time horizon and risk tolerance of their children (i.e., the primary beneficiaries of the trust), not themselves. The second scenario is identical to the first, except that Adam and Eve would increase their gifts to the trust to $112,000 per year[45] to maximize their unused annual exclusions. The third scenario is identical to the second, except that the trustee of the ILIT would (1) retain the two life insurance policies, using $30,000 from each annual contribution to pay policy premiums; and (2) invest the remainder of each annual contribution—$82,000 per year—in the 70/30 portfolio. Our projections of median, inflation-adjusted, after-tax wealth to the beneficiaries for each scenario are shown in Display 7.[46]

Display 7: A Plan that Integrates Life Insurance Tends to Match Beneficiaries' Needs Better than an Unhedged Plan



*"Median Family Wealth After Estate Tax" means 50th percentile outcome of Bernstein's wealth forecasting model, plus aggregate insurance death benefit, if any, reduced by federal taxes for any wealth held on personal balance sheet. "Year of Death" means the year of death of the last of the insureds to die. We computed estate taxes assuming remaining federal exclusion of $10.9 million indexed for inflation in accordance with applicable law, assuming annual inflation of 2.7%.
Based on Bernstein's estimates of the range of returns for the applicable capital markets over the applicable period. **Data do not represent past performance and are not a promise of actual future results or a range of future results.** Bernstein does not provide legal, tax, or insurance advice; investors should consult experts in those areas before implementing any insurance strategy.
Source: AB

As you can see, the first two scenarios—in which the two insurance policies are surrendered—result in upward-sloping lines; in other words, the children should expect to receive the *most* money when they need it *least*—when they are older. In contrast, the third scenario—in which the insurance policies are maintained—produces a wealth curve that is downward-sloping; in this scenario, the children should expect to receive the *greatest* amount of wealth when they need it *most*—when they are young. Importantly, when we compared the wealth curve from the third scenario with our estimate of the aggregate core capital needs of the children over time, we found that our wealth projection closely coincided with G2's aggregate core requirement.

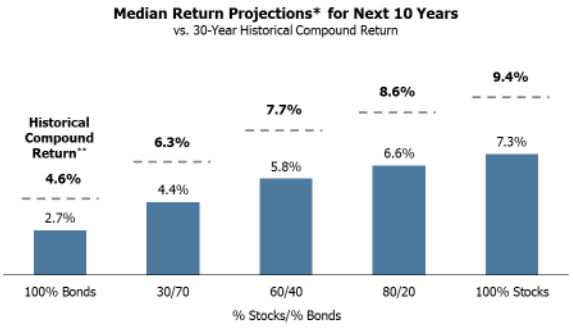
This case illustrates the benefit of our needs-based, integrated planning methodology. Adam and Eve thought that, if anything, they might be over-insured. In fact, we found, based upon the needs of their children, that they are appropriately insured when we take into account and integrate their estate and investment plans. It takes more work—and cooperation among

professional advisors—to reach a result like this, but to date, for our clients with whom we've used this methodology, it has been well worth the effort.

Private Placement Life Insurance (PPLI): The *Opposite* of Life Insurance?

Perhaps the most daunting challenge facing investors today is that both stocks and bonds are unlikely to enjoy the kinds of returns in the future that we have seen over the past 30 years. As can be seen in Display 8, the compound annual growth rate for diversified municipal bonds over the next ten years is likely to be well below three percent, with global stocks expected to struggle to compound at more than seven percent. In each case, these expected returns are well short of historical norms. It's possible to achieve 10 percent 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 possible 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.

Display 8: Future Returns Are Likely to Be Lower



Based on Bernstein'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 future results or a range of future results.** See Appendix, Notes on Wealth Forecasting System, for details.
*Blue bars represent Bernstein's projected pretax 10-year compound annual growth rate. "Stocks" means MSCI World; "Bonds" means diversified intermediate-term municipal bonds. Reflects Bernstein's estimates and capital-market conditions as of June 30, 2018.
**Dotted grey lines represent historical compound return calculated from July 1, 1988 through June 30, 2018. "Stocks" means 70% S&P 500 and 30% MSCI EAFE from 1986 through 1987, and 70% S&P 500, 25% MSCI EAFE, and 5% MSCI EM thereafter; "Bonds" means Lipper Short/Intermediate Municipal Bond Fund Average.
Sources: Lipper, MSCI, Standard & Poor's, and AB

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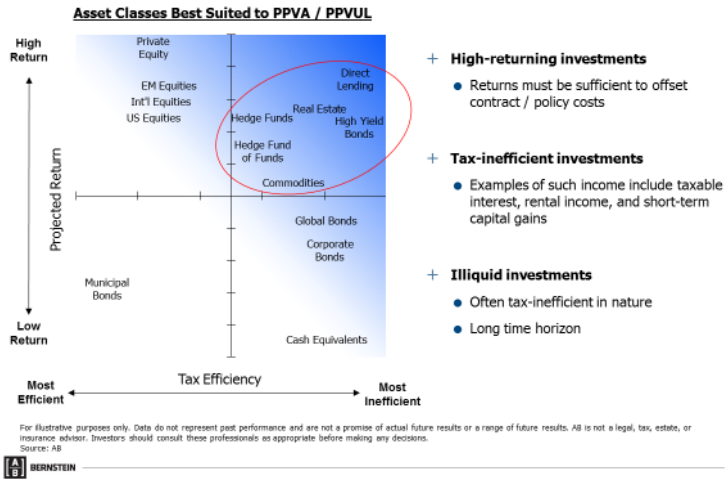
One potential solution to this dilemma is to concentrate high-returning, tax-inefficient investments in one's tax-deferred qualified retirement plan or individual retirement account (IRA). But many investors don't have adequate funds set aside in those kinds of accounts to take full advantage of their tax-deferred nature. For those investors, we have found it useful to package high-returning, tax-inefficient investments in a portfolio that can be accessed through a low-cost, "private placement" life insurance (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.[47] And if policy premiums are paid gradually (generally, in at least four roughly equal installments) rather than immediately, cash value may be accessed during the insured's lifetime without incurring income tax.

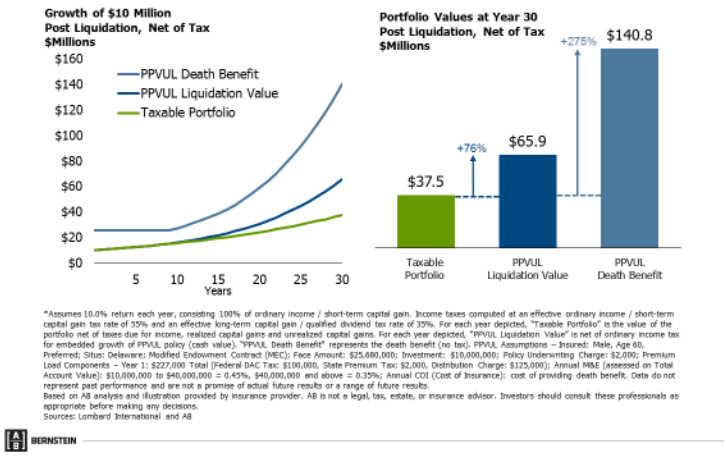
For example, assume that an investor is interested in acquiring certain alternative investments that have the potential to produce a 10 percent pre-tax annual return, but all of that return is taxable currently as a combination of short-term capital gain and ordinary interest income. Display 9 provides examples of the types of high-returning, tax-inefficient alternative investment strategies that are likely to benefit most from PPLI. Short-term capital gain and ordinary income is taxed by the federal government at rates currently as high as 37 percent; if categorized as "net investment income," there may be an additional 3.8 percent federal surtax[48]; and 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 percent. If the investor doesn't have sufficient capacity in her qualified plan or IRA, a 10 percent pre-tax annual return in these alternative investment strategies may produce an after-tax return of less than five percent—arguably not worth the trouble.

Display 9: Most Suitable Investments for PPLI



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 one percent per year—0.70 percent annual expenses[49] over the long-term are typical for a well-designed policy on a reasonably healthy insured. If that expense estimate is accurate, then in this example, the investor's five percent after-tax annual return outside of PPLI becomes a 9.3 percent after-expense return in the PPLI policy. As shown in Display 10, over the course of a single generation, PPLI can produce after-tax portfolio values and death benefits that are two to four times higher than had comparable investments been made through a taxable account.

Display 10: The Power of Compounding in a Tax-Free Environment



"Assumes 10.0% return each year, consisting 100% of ordinary income / short-term capital gain. Income taxes computed at an effective ordinary income / short-term capital gain tax rate of 35% and an effective long-term capital gain / qualified dividend tax rate of 35%. For each year depicted, "Taxable Portfolio" is the value of the portfolio net of taxes due for income, realized capital gains and unrealized capital gains. For each year depicted, "PPVUL Liquidation Value" is net of ordinary income tax for embedded growth of PPVUL policy (cash value). "PPVUL Death Benefit" represents the death benefit (no tax). PPVUL Assumptions – Insured: Male, Age 60, Preferred; Situs: Delaware; Modified Endowment Contract (MEC); Face Amount: $25,680,000; Investment: $10,000,000; Policy Underwriting Charge: $2,000; Premium Load Components – Year 1: $227,000 Total (Federal DAC Tax: $100,000, State Premium Tax: $2,000, Distribution Charge: $125,000); Annual M&E (assessed on Total Account Value): $10,000,000 to $40,000,000 = 0.45%, $40,000,000 and above = 0.35%; Annual COI (Cost of Insurance): cost of providing death benefit. Data do not represent past performance and are not a promise of actual future results or a range of future results.
Based on AB analysis and illustration provided by insurance provider. AB is not a legal, tax, estate, or insurance advisor. Investors should consult these professionals as appropriate before making any decisions.
Sources: Lombard International and AB

BERNSTEIN

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 are much higher than those associated with PPLI. This combination of higher expected portfolio 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.

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. Any at 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 *longevity*, not a hedge against mortality. A truly

diversified insurance plan for wealthy clients should include both traditional and PPLI elements.

Most investment managers who operate in the PPLI space have taken one of two approaches to portfolio construction. Those who have developed diversified portfolios rely largely or entirely on traditional stock and bond funds. Those strategies are expected to produce relatively low returns and usually are quite tax-efficient, and therefore are not best suited for PPLI. Other managers have created "stand-alone" alternative portfolios, consisting of securities and other financial instruments designed to support a single investment thesis. Although those portfolios tend to be both high-returning and tax-inefficient, it's risky to base a life insurance policy—presumably a long-term strategy—on a single investment theme. To avoid this concentration risk, PPLI policyholders can cobble together a portfolio of multiple stand-alone alternative strategies, but few have the expertise or wherewithal to do so in a way that is likely to maximize return and minimize risk over the long haul. We propose a third approach: A diversified portfolio of largely (ideally, about 80 percent) alternative investment services that are uncorrelated to one another and to the broader markets, are likely to produce high returns, and are mostly tax-inefficient. The balance of the portfolio (about 20 percent) consists of traditional stocks and bonds, to provide liquidity and promote portfolio diversity. This portfolio should be actively managed, so that policyholders will not need to cobble together a collection of stand-alone funds and rebalance that collection on their own as market conditions change in the future. Based upon our study, such a portfolio, if carefully constructed and managed, should outperform global stocks by two percent or more per year.

Who should be the insured under a PPLI policy? Short answer: The insured should be that individual or those individuals who allow the purchaser to get best pricing on PPLI. When working with a family, every family member is "in play" in determining who will be the insured. Numerous factors must be considered, including the insurance carrier's financial underwriting process, which places limits on how much NAR may be placed on a particular individual. Age and health of the prospective insureds are also key variables. The result of this complex underwriting process is often counterintuitive. Consider, for example, a family that would like to invest $10 million in PPLI. We are considered two potential insureds: A 65-year-old father and his 35-year-old daughter, both healthy and quite wealthy by life insurance industry standards. Because the daughter is so young, $10 million of premium would result in a death benefit of about $70 million if she were the insured; the NAR (that is, the spread between the death benefit and the initial account value) at inception is $60 million. In contrast, $10 million of premium would result in a death benefit of about $32 million if the father were the insured; the NAR at inception is $22 million. Although the cost per unit of risk is likely to be substantially lower on daughter's life, (1) the daughter may not have enough assets of her own to support $60 million of risk to the insurance carrier; and (2) costs of insurance expressed in absolute dollars (rather than per unit of risk) may actually be lower on father than on daughter because his initial NAR ($22 million) is so much lower than hers ($60 million).

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 percent stocks and 20 percent 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 over 6.5 percent per year, pre-tax, over that period, compared to historical annual return of 9.4 percent for that asset mix. Going forward, inflation is likely consume two percent or more of annual return, and income taxes another 1.5 percent or so, leaving perhaps three percent, on average, available for distribution. If distributions to current beneficiaries are expected to be greater than three percent of portfolio value, the result is likely to be a *negative* real, after-tax 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) "wrap" the tax-inefficient portion of those alternatives in PPLI has the potential to reverse the outcome described in the foregoing example.

If a multi-generational trust is the purchaser, should the PPLI policy be structured as a modified endowment contract (MEC) or a non-MEC? It depends, but if the policy is being acquired primarily to preserve real, after-tax growth for the remainder beneficiaries, then arguably, PPLI purchased by a multi-generational trust should be structured as a MEC. A MEC has two big advantages—and one potential disadvantage—relative to a non-MEC. A MEC may be thought of as a life insurance policy that is funded with a single, immediate premium—or nearly so. By stuffing premium into the policy, more dollars may be invested in tax-inefficient alternatives more quickly than if premiums were paid gradually. In addition, policy expenses associated with a MEC often are lower than those associated with a non-MEC. But there is a significant downside to a MEC: If the policyholder (the trustee, in this example) wants to access policy cash value during the lifetime of the insured, withdrawals or loans from a MEC are treated first as coming from growth, taxable at the highest marginal (that is, ordinary) income tax rates. Only after all the growth has been distributed are subsequent withdrawals from a MEC treated as a tax-free return of premiums. If withdrawals during the life of the insured are contemplated, then a non-MEC—where premiums usually are paid in at least four roughly equal annual installments—may be advisable. In a non-MEC, withdrawals are treated first as a tax-free return of premium. Only after all premiums have been withdrawn are additional withdrawals treated as ordinary income, but even that tax result can be defeated by borrowing, rather than withdrawing, additional sums from the policy. And the annual cost to the policyholder of borrowing against PPLI cash value is incredibly cheap; the interest-rate spread[50] on a policy loan is currently about one-third of one percent, and is guaranteed never to exceed 0.50 to 0.70 percent per year by most insurance carriers. But a non-MEC cuts into investment return, due to both opportunity cost (because dollars are invested in alternatives more gradually) and higher policy expenses. If investment in PPLI is intended primarily for the remainder beneficiaries, why is the trustee concerned about policy withdrawals during the life of the insured? A robust discussion around this question among the trustee and his team of advisors is essential.

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 drag due to income taxes. Further assume that she would like to start taking withdrawals to help finance her retirement starting at age 65. PPLI structured as a non-MEC may be a perfect solution for this entrepreneur. If she were to fund a PPLI policy in four annual premium installments of $1 million each and the policy's diversified alternative investment portfolio were able to achieve compound annual growth of 10 percent before policy expenses, a healthy entrepreneur may have cash value of more than $14 million available for retirement income starting at age 65. If the policy were a properly structured non-MEC, the entrepreneur's first $4 million of withdrawals would be treated as tax-free return of premium, and she could borrow the remaining $10 million at an interest-rate spread guaranteed never to exceed 0.50 to 0.70%, depending upon the insurance carrier she selects.

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 the development of 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 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.[51] Bottom line: Customization is possible, but potentially dangerous. The safer strategy is to choose from among the portfolios that insurance carriers make available for investment through PPLI. We expect those offerings to expand in the future, and policyholders will be free to reallocate among those future offerings without incurring current income tax or policy fees.

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).[52] 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; (2) very few insurance carriers currently allow SMAs; and (3) some legal advisors believe—we think erroneously—that IDFs are "safer" than SMAs.[53]

When you look at your first PPLI illustration, one thing probably will jump out at you: 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 expense drag on the portfolio. 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 a mistake—which may be attributable to an insurance advisor who does not understand the true power and purpose of PPLI.[54]

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. Further, the carrier may choose to retain only a small portion of that risk; the balance usually is ceded to the global reinsurance market, which consists of multiple, highly capitalized global insurance superpowers. At least one major PPLI carrier retains only $175,000 of risk per policy; most PPLI carriers retain $10 million of risk. If the insurance carrier were to become insolvent, the potential loss to the policyholder generally would be limited to "retention"—that is, the amount of risk that the insurance carrier retains on any policy. The lower the carrier's retention, the less credit rating matters.

Conclusion

The best way to think about the integrated process espoused in this article may be this: Sound investment and estate planning can produce amazing results for our clients, but those benefits usually take time to manifest. The proper role of traditional life insurance should be to cover the risk that the senior generation may die too soon to realize those benefits. PPLI has a very different purpose: To harness the income tax efficiency of life insurance in the most productive way possible. Complexity is rampant. By working together, an integrated team—attorney, CPA, investment managers, insurance advisor, valuation experts, and others as circumstances warrant—is able to produce results that are far superior to what may be accomplished by any one team member acting alone. In the complex science of planning in a post-ATRA, post-TCJA world, the whole is far, far greater than the sum of its parts.

[1] The death of the hypothetical insured in this case must be the result of a true accident. Typically, a death benefit claim is subject to a two-year "contestability period," during which the insurance carrier may deny payment on any one of several grounds, including suicide.

[2] Consider, for example, a grantor retained annuity trust (GRAT), which can shift growth of an asset in excess of the "hurdle rate" established pursuant to Section 7520 of the Internal Revenue Code (Code or I.R.C.) to the next generation with very little wear and tear, but which can successfully transfer wealth free of estate tax only if the grantor survives the fixed annuity term of the trust. Similarly, having the grantor retain the obligation to pay income taxes with respect to assets transferred to an irrevocable ("intentionally defective") grantor trust (IGT) can greatly enhance the value of the assets held in that trust, but the accumulated benefit of tax-free investing takes time to build. If the grantor were to die shortly after establishing either of these two strategies, the transfer tax benefits may be significantly impaired.

[3] According to research published by the M Financial Group of insurance advisors, a healthy, wealthy 65-year-old man has a one-in-four chance of living to age 98; a woman of the same age, health, and wealth has a one-in-four chance of living to age 101. Across a wide swath of ages and both genders, wealthy individuals tend to outlive their less "fortune"-ate counterparts by six to eight years. The correlation between wealth and longevity in the United States is astounding, but in our experience, it is generally—and unfortunately—ignored by most financial and estate planning professionals. As a result, many wealthy people either forego life insurance altogether—assuming, erroneously in our opinion, that it's a bad investment—or purchase products that are designed for the "retail" market and are not priced to reflect the longevity advantage of the wealthy. When assessing life insurance proposals for the wealthy, professional advisors should ask whether the products being considered are priced for the high net worth market, and if so, how that pricing is reflected in the policy expenses or other features. *See generally* Harold D. Skipper & Wayne Tonning, The Advisor's Guide to Life Insurance (M Financial Group 2013).

[4] After ATRA extended the $5 million, inflation-adjusted basic exclusion amount, many financial advisors and others recommended that clients dump some or all of their existing life insurance coverage, which they may have acquired to finance an estate tax liability based upon a much lower exclusion. Typically, the justification provided was that "you don't need it anymore." That impulse to dump existing coverage due to lack of need only intensified when TCJA doubled the basic exclusion amount, effective as of 2018. Our typical response to such a recommendation is, "It's a question of *want*, not need. Does the client *need* those Apple shares in her equity portfolio? Does she *need* that City of Cleveland sewerage bond in her municipal fixed income portfolio? The client may not 'need' this particular insurance policy, but she may *want* it because of the mortality protection it provides. Let us run an analysis to determine whether keeping it—or converting it to something more suitable in a tax-free Code Section 1035 exchange—may be preferable to cashing it in." Read on to learn how we would conduct that analysis.

[5] When the value of a closely held business interest exceeds 35% of the adjusted gross estate of a decedent, the estate may elect to pay federal estate tax in installments over a total period of 14 years. *See* I.R.C. § 6166(a).

[6] Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387 (1988). In *Graegin*, Tax Court Judge Jacobs determined that loan interest reasonably and necessarily incurred to pay federal estate tax is deductible as an estate administration expense under Code Section 2053.

[7] In a typical case, the policy is acquired by the trustee of an irrevocable life insurance trust (ILIT) using funds contributed to the trust by the insured. If the insured does not retain "incidents of ownership" (e.g., the ability to borrow against cash value) over the policy, the death benefit proceeds should avoid estate tax upon the insured's death. *See* I.R.C. § 2042; *see also* infra, note 23. Ordinarily, whenever a contribution is made to the ILIT, each trust beneficiary is granted a temporary withdrawal right (a so-called "*Crummey* power," which bears the name of the Tax Court case that made such powers famous) over a specified portion of the contribution that is less than or equal to the annual exclusion amount—currently, $15,000 per donor, per beneficiary, per year. The *Crummey* withdrawal right, if properly structured, should cause that portion of the contributed funds to be a "present interest in property"—a necessary condition to qualify for the gift tax annual exclusion. *See* I.R.C. § 2503(b). As a general rule, the policy design will call for annual premium payments that are less than or equal to the aggregate annual exclusion gifts that may be made to current beneficiaries of the ILIT. For example, if the trustee acquires a second-to-die policy on the joint lives of the senior generation (husband and wife) and there are 10 current beneficiaries of the ILIT, the maximum annual contribution that may be made to the trust without using any of the senior generation's combined $22.8 million basic exclusions or paying gift tax is $300,000 (= two donors x 10 beneficiaries x $15,000 per beneficiary). In traditional life insurance planning, the amount of illustrated premium to be paid each year frequently equals or is just below the aggregate annual exclusions available to the senior generation—probably just a coincidence! With this article, we hope to debunk this type of dogmatic, tax-law-of-the-moment-driven insurance planning.

[8] Pub. L. 112-240, 126 Stat. 2313 (2013), effective after Dec. 31, 2013; Pub. L. 115-87 (2017), https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf, effective after Dec. 31, 2017. The Senate

parliamentarian determined that the short title "Tax Cuts and Jobs Act" violated the so-called Byrd rule, so that title was dropped from the final version of the legislation. This article is not subject to the Byrd rule, so at least for now, we choose to identify Public Law 115-87 as "TCJA."

[9] *See* https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2019, I.R.S. News Release 2018-222 (Nov. 15, 2018).

[10] *See, e.g.*, Steve R. Akers, "Heckerling Musings 2018 and Current Developments," at 28 (Apr. 2018), available at www.bessemer.com/advisor.

[11] Both spending and inflation-adjusted growth of the basic exclusion amount contribute to this potential outcome. Based upon our most recent median projection for inflation, we believe that the combined basic exclusions for a married couple will grow from $22.8 million today to $26.8 million in 2026—unless TCJA sunsets after 2025, as currently scheduled. See infra, text titled "Sidebar: Core Capital and Wealth Forecasting," for a description of Bernstein's wealth forecasting model, which projects future inflation and a host of other variables.

[12] For an excellent survey of existing and repealed state death tax laws for all 51 U.S. jurisdictions, updated as of July 25, 2019, see http://media.mcguirewoods.com/publications/State-Death-Tax-Chart.pdf.

[13] For a convenient summary of the highest marginal income tax rates for all 51 U.S. jurisdictions, see http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_FF500.pdf.

[14] *See* I.R.C. § 1015(a). There is an exception for gifts of depreciated property; in such a case, the basis for purposes of determining a *loss* in a subsequent taxable transaction is its fair market value on the date of the gift. *Id.*

[15] *See* 2018 Instructions for Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts, at 14 (instructions for Line 9b—State, Local, and Foreign Income Tax), available at https://www.irs.gov/pub/irs-pdf/i8960.pdf. Specifically, state and local income taxes paid that are attributable to net investment income reduce the tax base against which the 3.8% federal surtax is computed. Taxpayers in states that impose the highest income tax rates benefit the most from this deduction.

[16] Fair market value is based upon the price that a hypothetical willing buyer would pay a hypothetical willing seller for the asset in question, with neither party being under a compulsion to buy or sell, and both parties reasonably aware of all relevant facts. *See* Rev. Rul. 59-60, 1959-1 C.B. 237. In such a purchase and sale, the purchaser would take a cost basis pursuant to Code Section 1012(a). As a result, the adjusted basis of the seller immediately prior to the sale would be irrelevant to the purchaser. But in the case of a gratuitous lifetime transfer, the adjusted basis of the donor is incredibly important to the donee, as that basis "carries over" to the donee pursuant to Code Section 1015(a). Since the "willing buyer-willing seller" test is based upon a hypothetical *sale* rather than a transfer by *gift*, that test creates a distortion that estate planning professionals must take into account when advising clients about which assets are the best candidates for lifetime wealth transfer.

[17] *See generally* I.R.C. § 1014(b). Although this article consistently refers to the basis adjustment accorded to property that is "acquired from or [having] passed from the decedent" as a "step-up" in basis, such basis is stepped up *or down* to its fair market value on the date of the decedent's death, or in the case of a proper election under Code Section 2032, on the date that is six months after the date of the decedent's death. *See* I.R.C. §§ 1014(a)(1)-(2), 2032(a)(2). Alternate valuation, if elected, must reduce both the value of the decedent's gross estate and the amount of estate tax imposed; otherwise, basis generally equals date-of-death value. I.R.C. § 2032(c).

[18] If mom were to retain the asset and die tomorrow, her estate would be subject to estate tax based upon the asset's date-of-death fair market value (assuming no alternate valuation under Code Section 2032), but her estate could apply applicable exclusion to offset the amount of estate tax owed. If she instead transferred the asset to her daughter today and died tomorrow, she would use applicable exclusion equal to today's date-of-gift value, but her gross estate would be reduced by the fair market value of the asset tomorrow. The only estate tax consequence would be based upon the appreciation or depreciation in the value of the asset during the 24-hour period between her gift today and her death tomorrow. In almost every case, the economic detriment to the donee of a loss of the step-up in basis that would result from a lifetime transfer would greatly exceed any estate tax savings realized from the potential growth in the asset over a one-day period. For a highly appreciated asset, it may take *years*, not days, to overcome that hurdle. Note, however, that if mom lived in a jurisdiction that imposed a state death tax, but not a state gift tax, a lifetime wealth transfer may alter the overall transfer tax dynamics profoundly; careful analysis is required in such a case.

[19] A step-up in basis may be irrelevant if (1) the donee intends to hold the donated asset until death; and (2) the asset is not expected to generate depletion, depreciation, or amortization deductions during the donee's lifetime. But a client's "I-will-never-sell" assertions should be taken with several large doses of salt.
[20] Note, however, that if a "reduction in benefits" during the first 15 years of a policy "results" in a cash distribution to the policyholder, some or all of the distribution may be taxable as ordinary income. *See* I.R.C. § 7702(f)(7)(B); *see also* Rev. Rul. 2003-95, 2003-33 I.R.B. 358 (Aug. 18, 2003).
[21] *See generally* I.R.C. § 2702 and the Treasury Regulations thereunder.
[22] A SLAT may be particularly useful for married clients who want to engage in lifetime wealth transfer, but may not be confident enough to relinquish permanently the assets being transferred. In the simplest case, one spouse, as grantor, transfers assets to an irrevocable trust of which the other spouse is a permissible beneficiary. If the couple runs short of money in the future—due to a downturn in the markets, unexpected health care expenses, or otherwise—the trustee of the SLAT can make a discretionary distribution to the beneficiary spouse that meets the standard for distribution under the trust instrument. If carefully drafted and implemented, the date-of-death value of the assets in the SLAT should avoid estate tax upon the deaths of both the grantor spouse and the beneficiary spouse. Further, each spouse may be able to establish a separate SLAT for the benefit of the other, assuming that those trusts do not violate the so-called "reciprocal trust doctrine" established in United States v. Estate of Grace, 395 U.S. 316 (1969). For further commentary, see Mark Merric, "Can Husband Create Irrevocable Trust for Benefit of His Wife and Vice Versa?" available at http://internationalcounselor.com/Merric%20Law%20-%20Documents/reciprocaltrust5.pdf. Legal technicalities aside, two things can really mess up a SLAT: (1) divorce and (2) death of the beneficiary spouse—so proceed with caution when implementing this strategy.
[23] Care should be taken to ensure that the insured does not retain "incidents of ownership" over the life insurance policy within the meaning of Code Section 2042; otherwise, the life insurance proceeds may be subject to estate tax upon the insured's death.
[24] 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); *see also* supra, note 15.
[25] With respect to certain real estate placed in service prior to 1986 for which accelerated depreciation was allowable, those deductions are recaptured at *ordinary* rates under Code Section 1245. Thereafter, with respect to real estate for which straight-line depreciation generally is required, those deductions are recaptured at the 25% (rather than 20%) rate on "unrecaptured section 1250 gain." *See* I.R.C. § 11(h)(1)(E). For an excellent discussion of lifetime wealth transfer applications for unique asset classes, including depreciable real estate, see Paul S. Lee, "Venn Diagrams: The Intersection of Estate & Income Tax (Planning in the ATRA-Math)," 48th Annual Heckerling Institute on Estate Planning (Jan. 2014), at 24-39.
[26] *See* I.R.C. § 2010(c)(4)-(6).
[27] For a concise summary of the rules contrasting required minimum distributions for qualified retirement plan and individual retirement account assets passed at death directly to a surviving spouse, as compared to others, see https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Required-Minimum-Distributions-(RMDs).
[28] I.R.C. § 2010(c)(5)(A).
[29] The "deceased spousal unused exclusion" is defined at Code Section 2010(c)(4).
[30] In addition, states generally do not recognize portability for state death tax purposes, with two current exceptions: Maryland (retroactive to 2011) and Hawaii. *See* Md. Code, Tax-Gen. § 7-309(b)(9); Haw. Rev. Stat. tit. 14, § 236E-3.
[31] *See* http://www.indexarb.com/dividendYieldSortedsp.html (for current S&P 500 dividend yield); http://finance.yahoo.com/q?s=^TNX (for current 10-year U.S. Treasury bond yield). As of August 27, 2019, the dividend yield for S&P 500 stocks was 2.32% and the 10-year Treasury yield was 1.49%. Thus, a $1 million portfolio consisting of 60% S&P 500 stocks and 40% 10-year Treasuries currently yields $19,880 (= $1,000,000 x {[60% x 2.32%] + [40% x 1.49%]}.
[32] In our methodology, certain expenses may be indexed at a rate greater than inflation. For example, in recent analyses for clients, we typically have indexed education expenses at inflation plus 2% and health care expenses at inflation plus 3% to reflect long-term historical growth trends for those categories.
[33] Society of Actuaries RP-2000 Mortality Tables, available at https://www.soa.org/research/experience-study/pension/research-rp-2000-mortality-tables.aspx.
[34] *See* supra, note 3.

[35] In analyses involving clients who are at or near retirement age, we ordinarily project 90th percentile market outcomes when computing their insurance gap. But for individuals and couples who may have time horizons in excess of 50 years, we typically use a "NextGen calculator," which employs a glide path confidence level that increases gradually to 75% by the time the investors reach core. We believe that this method appropriately balances reasonable conservatism with the reality that younger investors have a greater capacity to add to their portfolios (e.g., through salary increases or changes in spending patterns, etc.) and to absorb periodic market losses than many older investors.

[36] Many people assume that term insurance provides the best solution in cases like these—and that often is true. But we suggest that the insurance advisor be given the opportunity to select from an array of products, based upon that advisor's own experience, analysis, and sound judgment. Re-testing to include the premium costs in our analysis readily allows us to identify cases in which the proposed insurance solution is too expensive.

[37] By "planned lapse," we mean that the risk of lapse has been offset by an estate planning or other hedge. For example, a 10-year GRAT may be hedged with a 10-year term life insurance policy. If the GRAT were to fail due to the grantor's death during the annuity term, the insurance hedge would pay off. Conversely, if the grantor were to survive the annuity term, the 10-year term policy would lapse, but the successful GRAT—assuming that the capital markets cooperate—should more than adequately compensate the beneficiaries for that loss.

[38] *See, e.g.*, Julie Creswell and Mary Williams Walsh, "Why Some Life Insurance Premiums Are Skyrocketing," N.Y. Times (Aug. 13, 2016), available at http://www.nytimes.com/2016/08/14/business/why-some-life-insurance-premiums-are-skyrocketing.html?_r=0; Leslie Scism, "Retirees Stung by 'Universal Life' Costs," Wall St. J. (Aug. 9, 2015), available at https://www.soa.org/research/experience-study/pension/research-rp-2000-mortality-tables.aspx.

[39] One UL illustration that we recently reviewed indicated that the carrier's current crediting rate of 5.05% had been applied for the duration of the analysis. But an additional "persistency credit" in the later years of the policy caused the illustrated cash value to increase at a much greater rate—in excess of 20%, net of policy expenses, in certain years. A representative of the carrier explained that the illustrated persistency credit was based upon certain categories of alternative investments in the carrier's general account that were expected to provide a tremendous pay-off over the long term. Those optimistic returns may come true, but purchasers should be skeptical of relying upon nonguaranteed cash value and death benefit projections, especially when they are based upon stocks and other speculative investments that may underperform.

[40] We've heard some insurance advisors assert that, when comparing life insurance to a capital market portfolio, the "only fair comparison" is an all-bond portfolio. That's hogwash. The appropriate test—in our minds, the only appropriate test—is: "How would *this client* invest the money if it weren't invested in life insurance." Ordinarily, the answer is that it would be invested at the client's strategic allocation. In certain cases, the answer may deviate from that allocation. But for the most part, the investment of funds in our model will mimic how the client would invest if those funds weren't dedicated to life insurance.

[41] *See* supra, note 4.

[42] Some claim—falsely—in promotional materials that the estate tax liability is "eliminated" by this plan. In fact, this plan merely finances the estate tax; it doesn't eliminate it.

[43] The one exception—the one estate planning strategy that works most like an insurance policy—is a valuation discount. If a gift or sale of a discounted asset can be undertaken, and if that discount can be successfully defended on audit, then the family derives an *immediate* economic benefit that does not take time to manifest. That is precisely what life insurance does. In 2016, Treasury issued—and subsequently withdrew—proposed regulations that would, when finalized, have greatly reduced or eliminated valuation discounts for family-controlled entities. *See* REG-163113-02, 81 Fed. Reg. 51413 (Aug. 4, 2016), *withdrawn*, 82 Fed. Reg. 48779 (Oct. 20, 2017). If these regulations ever resurface, life insurance may be the cheapest and best way for most families to replicate the instantaneous financial benefits that currently are associated with valuation discounts.

[44] *See* Rev. Proc. 2004-64, 2004-27 I.R.B. 7 (Jul. 6, 2004).

[45] At the time of this analysis, the gift tax annual exclusion was $14,000 per donee, per year; it has since increased to $15,000.

[46] This case predates TCJA, and thus does not reflect the enhanced basic exclusion amount—currently $11.4 per person, indexed for inflation—that is scheduled to sunset after 2025.

[47] *See generally* I.R.C. § 101. Certain "transfers for value" during the lifetime of the insured 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).
[48] *See* supra, notes 15 and 24.
[49] PPLI annual expenses usually include a mortality and expense (M&E) charge of 0.35 to 0.55% per year, plus costs of insurance (COIs) that usually amount to 0.15 to 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). *See* infra, notes 51 and 52.
[50] This "interest-rate spread" is the difference between (1) the interest rate charged by the carrier on the policy loan and (2) the rate credited to the policyholder on the collateral component of the policy's cash value.
[51] For an egregious example of this type of policyholder behavior, see Webber v. Commissioner, 144 T.C. 324 (2015).
[52] *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).
[53] SMAs are not expressly mentioned in Section 1.817-5 of the Treasury Regulations; requirements for IDFs are expressly provided in Section 1.817-5(f). But those requirements are not exclusive, as evidenced by the fact that the first word in subsection (f) is "If"—as in: "If" the following requirements are met, then the fund is an IDF and qualifies for "look-through" treatment. By implication, then, an SMA does not qualify for look-through treatment, but it doesn't follow that SMAs are disallowed. The negative inference that some insurance carriers and professional advisors draw from this regulatory provision is puzzling.
[54] Many insurance advisors do not want to place PPLI cases, as their compensation in those products tends to be much lower than in traditional life insurance products. In addition, properly structured PPLI has many counterintuitive features; an insurance advisor who has little or no PPLI experience may not understand how correctly to illustrate the policy, which may create delays—or worse.