Leaning into Social Distancing: A Perfect Storm for Wealth Transfer

Background:

On March 9, 2009, the S&P 500 closed at 676.53, down 57% from its pre-financial-crisis peak. The very next morning, the longest bull market in the history of the stock markets began. Bernstein clients who funded a grantor retained annuity trust (GRAT) with marketable stocks on or about March 10, 2009 remain to this day among our happiest and most loyal clients.

Current conditions:

Fast-forward 11 years. As of this writing, the S&P 500 is 15% off its February 20, 2020 peak; as noted previously, on March 9, 2009, the S&P was down 57% from its peak. The April 2020 Section 7520 rate is 1.2%, and the May rate is 0.8%; by comparison, the March 2009 Section 7520 rate was 2.4%, which seemed very low at the time.

Of these two factors—market valuation and interest rates—valuation is, by far, the more important, whether the transfer strategy is a gift, GRAT, or installment sale to an "intentionally defective" grantor trust. History teaches that in the ten bear markets since World War II, the S&P 500 has risen 44%, on average, in the 12-month period following a trough, or low point, in the index.

Although the May Section 7520 will be 0.8%, for most of our clients, the time to act is now, in April, based on current valuations. Don't postpone wealth transfer initiatives involving marketable securities solely to capture a further dip in interest rates. In the current environment, an illiquid asset, such as an interest in a closely held business, may be valued at a substantial discount from its ultimate liquidation value; those discounts are likely to persist for the foreseeable future. On the other hand, readily marketable assets, such as publicly traded stocks, may be subject to significant upward and downward swings in value due to volatility; the urgency of a sale or other wealth transfer strategy may be heightened for such assets. A transfer to a grantor trust may be advisable in this environment, as it gives the grantor the opportunity to "swap" assets with the greatest prospects for future growth into the trust, without income tax consequence, in exchange for less "growthy" assets, and to change that mix from time to time as circumstances warrant.

Wealth transfer opportunities:

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

- <u>GRAT or installment sale to an irrevocable grantor trust</u>: Bernstein research shows that short-term, "rolling" GRATs work well irrespective of the market climate, although longer-term GRATs and installment sales of assets other than marketable stocks have a much greater chance for success when both valuations and interest rates are low. But even in the case of a rolling GRAT strategy, there is an emotional element: When the first GRAT in a planned series is successful, clients are substantially more likely to keep on rolling.

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

- <u>Value-shifting</u>: Arguably, the most provocative opportunity in the current wealth transfer environment is the <u>*long*</u>-term applicable federal rate (AFR), which is 1.44% in April 2020, and will be 1.15%—an all-time low—in May. The ability to lock in a rate that low for 15, 20, or even 30 years is profoundly game-changing: The longer a portfolio's time horizon, the more likely it will beat an interest-rate "hurdle." Based on results from Bernstein's wealth forecasting model, virtually *every* asset class, including cash, should soundly outperform a 1.44% or 1.15% annual interest-rate hurdle over the next 30 years. Clients can take advantage of the extraordinarily low long-term AFR to shift wealth over time from a "bad" place (e.g., a wealthy individual's balance sheet or a trust that is "nonexempt" for generation-skipping transfer (GST) tax purposes) to a much better place (e.g., a GST-exempt dynasty trust). This type of value-shifting is very difficult or impossible to replicate in a normal interest-rate environment.

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

- Refinancing intrafamily debt: In recent years, many families have used sales or loans at the prevailing AFR to transfer future growth of portfolios to family members or to trusts for their benefit. The extraordinarily low May 2020 AFRs may provide an excellent opportunity to refinance such debt. For example, a Bernstein client lent millions of dollars to an irrevocable grantor trust for nine years at the August 2012 mid-term AFR of 0.88%; that note will mature in August 2021. Our client plans to refinance that debt at the May 2020 mid-term AFR of 0.58%, extending the maturity date of the debt to May 2029. In such a case, most professionals will require the borrower to give up something—perhaps a modest payment down of principal—to get the benefit of a lower rate.

Conclusion:

Like March 2009, now is an extraordinary time to talk to clients about wealth transfer planning. Bernstein's wealth forecasting model can help investors conclude that they are able to afford these strategies, despite the current market turmoil. Give us call; we're here to help you help your clients achieve amazing results.