TAX AWARE

The Value of Integrating Income and Estate Planning

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In a recent Journal of Wealth Management article,[1] we discuss challenges of wealth preservation and growth faced by high net worth families. While it is not a surprise that a family that invests with income tax and estate tax efficiency in mind is much more likely to achieve its financial legacy goals than a family oblivious to taxes, the numerical advantages of tax efficiency described in the next paragraph are quite striking. In addition, we show that there is a significant value in integrating income tax efficiency and estate tax planning: *Becoming efficient with respect to one tax should make the family even more eager to become efficient with respect to the other*.

*"The family that is the most efficient with respect to income and estate tax achieves almost **three times** the after-tax wealth of a family inefficient with respect to both"*

Table 1 below[2] shows expected *after-tax* wealth at the end of a 40-year investment horizon for a hypothetical family which starts out with $100. The after-tax wealth is measured after income and estate taxes. Income tax efficiency increases across columns, from left to right, and estate tax efficiency increases across rows, from top to bottom. At the end of the investment horizon, the family that that is the most efficient with respect to income and estate tax achieves almost *three times* the after-tax wealth of a family inefficient with respect to both—$1,027 (bottom right) versus $359 (top left).

We offer a word of caution that, in pursuit of tax efficiency, investors should not disregard expected pre-tax returns. Rather, prudent investing, income tax efficiency, and estate tax planning should work in harmony to produce the best result for the family.

Table 1. Expected After-Tax Wealth at the End of a 40-Year Investment Horizon for a Hypothetical Family with Initial Wealth of $100.

	Income Tax Scenario					
Estate Tax Planning	Least Tax-Efficient	2	3	4	Most Tax-Efficient	Most vs Least Tax-Efficient
No Planning	$\boxed{359}$	415	482	561	654	295
Consecutive Five-Year GRATs	559	639	730	834	953	393
Consecutive Two-Year GRATs	580	665	762	876	1,007	427
Rolling Two-Year GRATs	586	673	774	891	$\boxed{1,027}$	441
Rolling GRATs vs No Planning	227	258	292	330	373	146

Source: Integration of Income and Estate Tax Planning. We use Monte-Carlo simulated data. As the estate planning tool, we use grantor retained annuity trusts (GRATs). We model five-year consecutive, two-year consecutive, and two-year rolling GRATs scenarios, alternatively. All the GRATs are zeroed-out GRATs. The GRATs are implemented until the end of the investment horizon. For example, for a forty-year horizon there will be eight consecutive five-year GRATs, twenty consecutive two-year GRATs, and thirty-nine rolling two-year GRATs. To the extent possible, taxes are paid outside of the remainder trust. We use probability of death that increases with age from the "2012 IAM Basic Table – Male, ANB" produced by the Society of Actuaries. The simulations proceed as follows. First, wealth of the family accumulates at the after-tax rate of return which is determined by the pre-tax return and the tax characteristics of the investment process: the character of the realized income, gains, and losses, and the amount of unrealized gains. We draw annual pre-tax returns from an i.i.d. normal distribution with a specified mean and standard deviation. Tax characters are applied as a fixed fraction of the pre-tax return. The pre-tax returns and the tax efficiency of the investment are the key parameters of interest in our study and we vary these parameters as explained further below. For each set of return parameters, we draw 20,000 forty-year return histories. Second, we apply mortality to the return histories. For example, if the probability of death in a given year is 1%, we apply death event logic to 200 out of our 20,000 return histories every year. In the event of death, the value of the assets passing through the estate is reduced by the estate tax, their cost basis is stepped up to the fair post-estate-tax market value, and the assets are reinvested by the family until the end of the forty-year investment horizon. Assets that are already in the estate-tax-exempt trust at the time of death of the grantor are unaffected. We assume investment in the same assets both inside and outside of the trust and thus use the same time series of simulated returns —one of the 20,000—for both. Finally, at the end of the forty-year investment horizon, all the assets are liquidated, and liquidation taxes are paid. Assets that at the time of death were in the personal account of the grantor and thus received a step up in the cost basis at death face a lower liquidation tax than the assets that were in the remainder trust at the time of death and thus did not receive a step-up in their cost basis. If the wealth creator is alive at the end of the forty-year investment horizon, none of the assets, either in the personal account or in the trust, benefit from the step-up in the cost basis at death prior to liquidation. We show the average results across our 20,000 return histories with their respective estate tax and liquidation tax situations. The pre-tax return is assumed to have a mean of 6.8% and a volatility of 10.0%. Tax inefficiency is modeled through varying the fraction of highly taxed income and gains from 70.6% for the least tax-efficient investment to 0% for the most tax-efficient investment. We assume tax rates of 23.8% for low-taxed gains and income and 40.8% for highly taxed gains and income. We assume that the Section 7520 rate which determines the GRAT annuity payments is 2.4%.

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[1] Sosner, Nathan, Joseph Liberman, and Steven Liu. 2021. "Integration of Income and Estate Tax Planning." *The Journal of Wealth Management* 24 (1): 78-104.

[2] Table 1 presents the same data as Exhibit 3, Panel B, in our article.

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Risks of Tax Aware Strategies (Not Exhaustive)

1. **Underperformance of pre-tax returns**: tax aware strategies are investment strategies with the associated risk of pre-tax returns meaningfully underperforming expectations.

2. **Adverse variation in tax benefits**: deductible losses and expenses allocated by the strategy may be less than expected.

3. **Lower marginal tax rates**: the value of losses and expenses depends on an individual investor's marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).

4. **Inefficient use of allocated losses and expenses**: the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and income realized by other investments, at-risk rules, limitation on excess business losses and/or net interest expense, or insufficient outside cost basis in a partnership.

5. **Larger tax on redemption or lesser benefit of gifting**: gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.

6. **Adverse changes in tax law or IRS challenge**: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.