

2012

## An Objective View of Insurance: Advanced Life Insurance Planning Case Studies (Slides)

Thomas J. Pauloski

---

### Repository Citation

Pauloski, Thomas J., "An Objective View of Insurance: Advanced Life Insurance Planning Case Studies (Slides)" (2012). *William & Mary Annual Tax Conference*. 669.  
<https://scholarship.law.wm.edu/tax/669>

# An Objective View of Insurance: Advanced Life Insurance Planning Case Studies

**58<sup>th</sup> Annual William & Mary Tax Conference**  
Williamsburg, Virginia  
November 9, 2012

**Thomas J. Pauloski, J.D.**  
Bernstein Global Wealth Management, Chicago, Illinois  
[thomas.pauloski@bernstein.com](mailto:thomas.pauloski@bernstein.com)

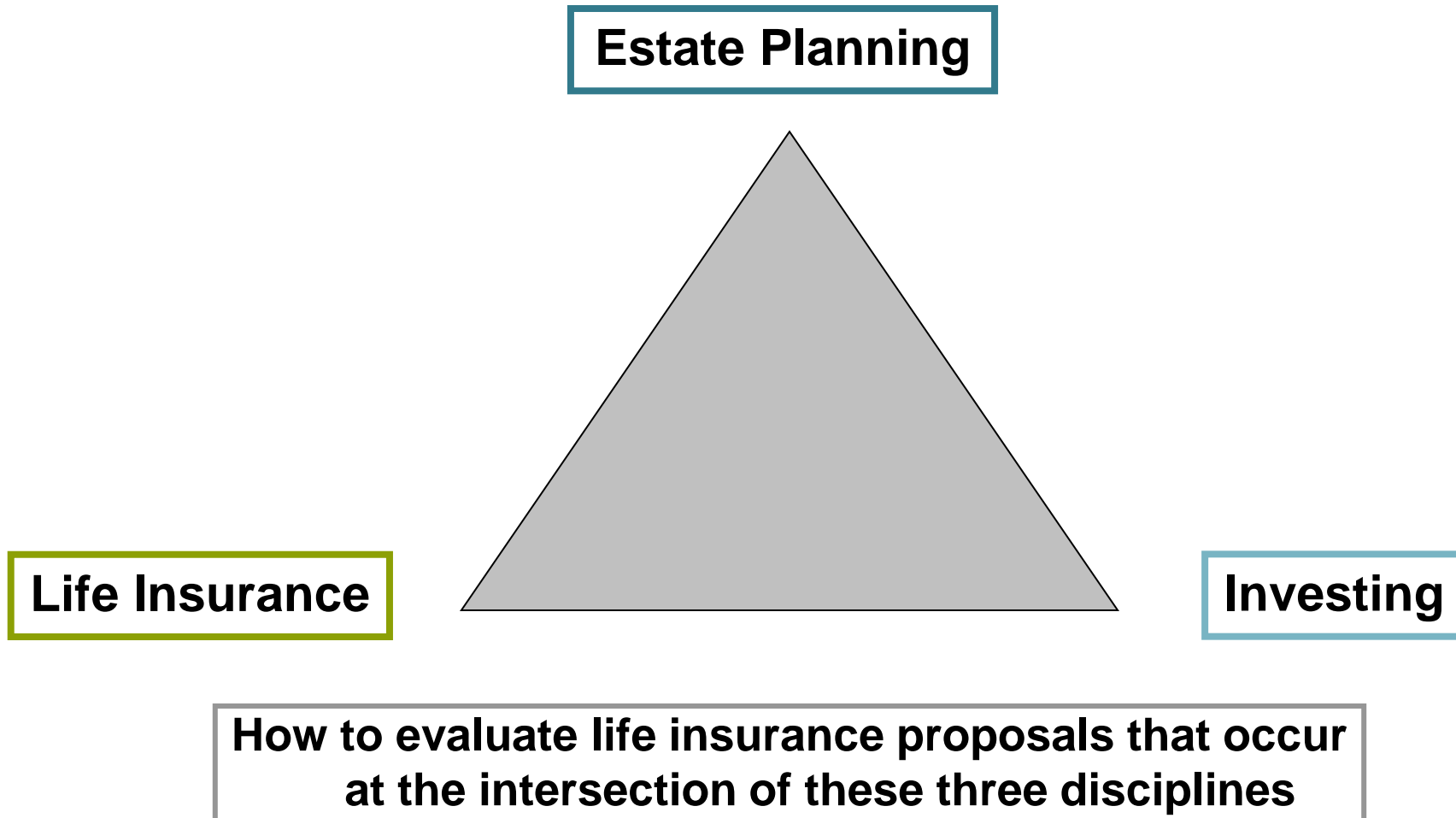


**Bernstein does not provide tax, legal, or accounting advice. In considering the information contained in this presentation, you should independently verify all conclusions before implementing any strategy on your own behalf or on behalf of your client.**

## What This Presentation is Not About

- **Basic estate planning with irrevocable life insurance trusts (ILITs)**
- **Overview of different life insurance product classes**
- **Tax rules applicable to life insurance policies**
- **Premium financing**
- **Stranger-owned life insurance (STOLI)**
- **Commercial annuities**

# What This Presentation Is About



# Agenda

- **Planning overview and analytical method**
- **Case studies**
  - **Blending life insurance with lifetime wealth transfer**
  - **Buy-sell agreement policy alternatives and evaluation**
  - **Insuring grantor retained annuity trust (GRAT) mortality risk**
- **Appendix: Observations about whole life insurance as substitute for municipal bonds**

# Planning Overview and Analytical Method

# Planning for Wealth Transfer: Core and Discretionary Capital



## Core Capital

- Assets required to ensure lifetime spending needs are met
- Calculated at 90% or greater level of confidence

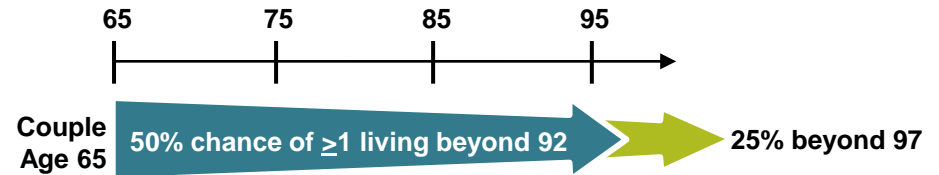
## Discretionary (or Excess) Capital

- Assets that can be transferred from one's balance sheet without affecting spending



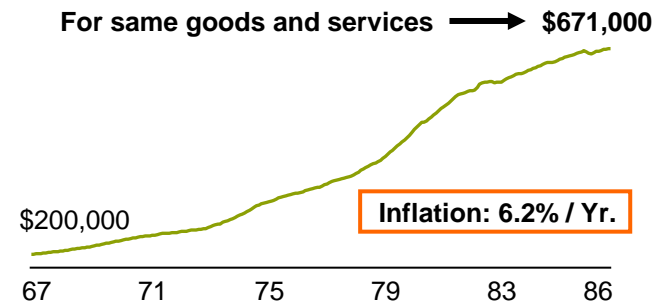
# Planning for an Uncertain Future: “What If...”

■ ... I live longer than expected, extending my spending into four decades?



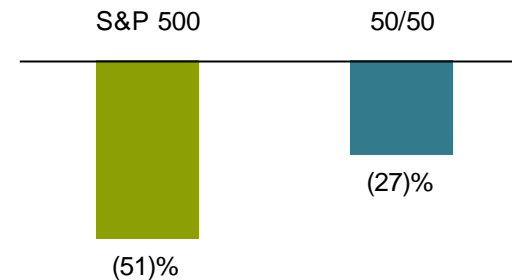
■ ... I’m hit by an inflation spike, with no earned-income to offset that hit?

## \$200,000 Annual Spending Grown with Inflation\*



■ ... I experience another bear market, immediately jeopardizing my wealth?

## Market Value Declines (Nov 2007–Feb 2009)\*\*



Longevity and mortality-adjusted investment analysis is based on mortality tables compiled in 2000.

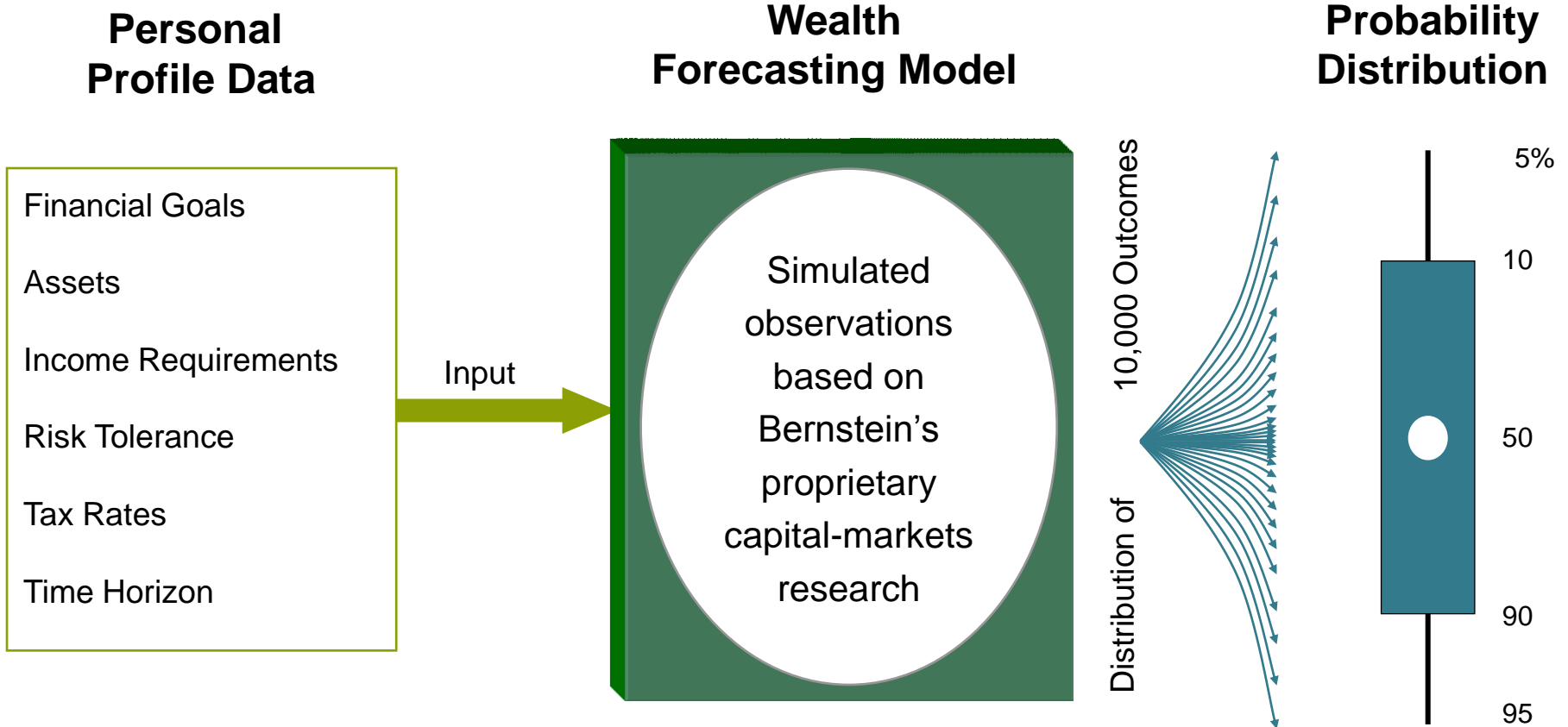
\*Inflation is represented by the Consumer Price Index.

\*\*Bonds are represented by the Barclays Capital US Aggregate Index.

Source: Barclays Capital, Bureau of Labor Statistics, Society of Actuaries RP-2000 mortality tables and Standard & Poor's

# Analytical Model\*

## Quantifying the Trade-Offs



\*See Appendix, Notes on Wealth Forecasting System, for details.

## **Case Study: Blending Life Insurance with Lifetime Wealth Transfer**

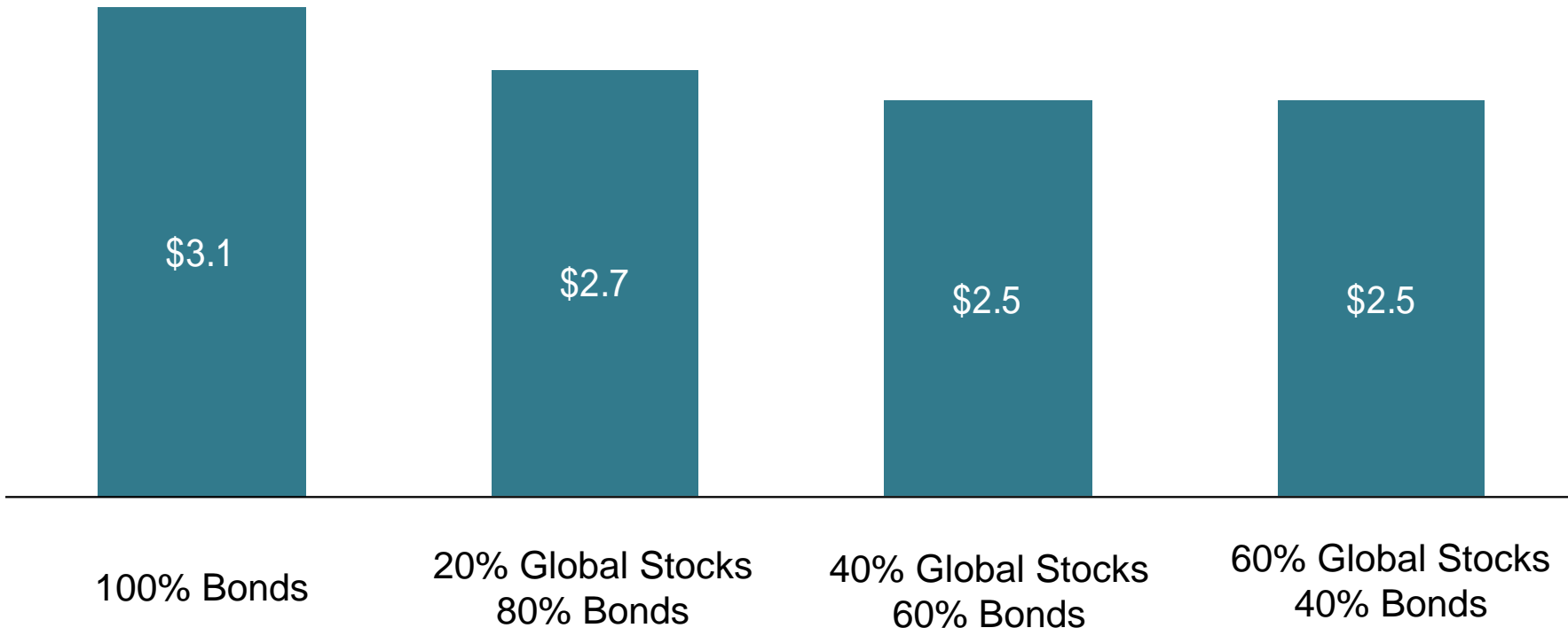
## Blended Wealth Transfer Plan: Case Study Facts

- **Married couple, age 80, IN residents**
- **\$25 million combined estate, all marketable securities**
- **Spend \$100,000 (inflation-indexed), after tax, each year—does not include life insurance premiums**
- **Time horizon: 20 years**

**Key Question: How much should they reserve for themselves?**

# Core Capital Is a Very Small Percentage of This Couple's Wealth

**Amount Needed to Fund Core Spending\***  
**Spend \$100,000 (Real) Annually, 20-Year Time Horizon, 95% Confidence**  
**\$ Millions**



Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

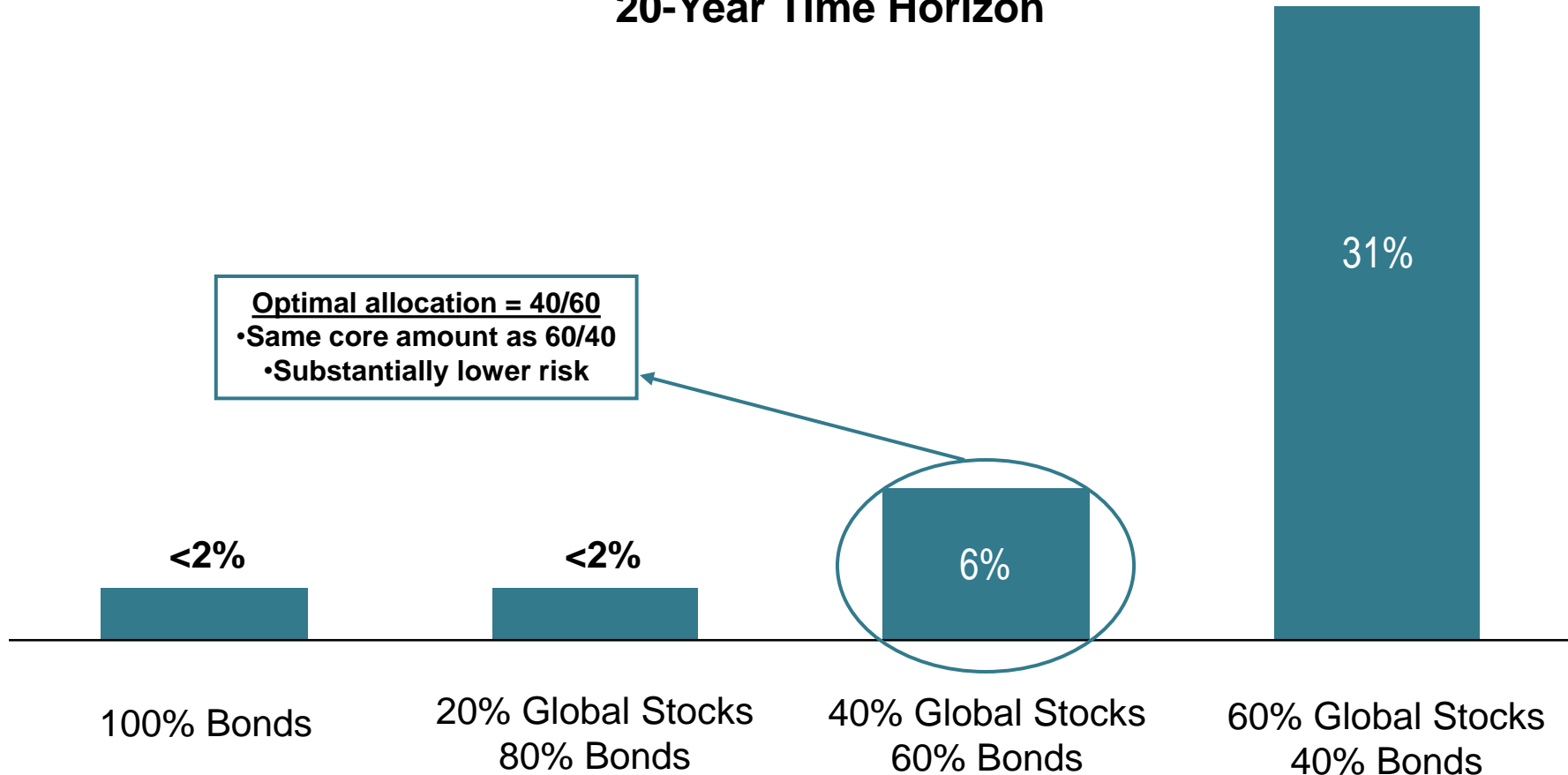
\*Core capital calculated at 95% level of confidence. Variations in actual income, spending, applicable tax rates, lifespan, and market returns may substantially impact the likelihood that a core capital estimate will be sufficient to provide for future expenses. "Global stocks" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

"Bonds" means intermediate-term municipal bonds.

Source: AllianceBernstein

# How Does Exposure to Equities Increase Portfolio Risk?

## Probability of 20% Peak-to-Trough Loss\* 20-Year Time Horizon



Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

\*Projections indicate probability of peak-to-trough decline in pre-tax, pre-cash flow cumulative returns of 20% over duration of forecast. Because Bernstein's Wealth Forecasting System uses annual capital market returns, probability of peak-to-trough losses measured on more frequent basis (such as daily or monthly) may be understated. Probabilities include upward adjustment intended to account for incidence of peak-to-trough losses that do not correspond to exact numbers of years. "Global stocks" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks. "Bonds" means intermediate-term municipal bonds.

Source: AllianceBernstein

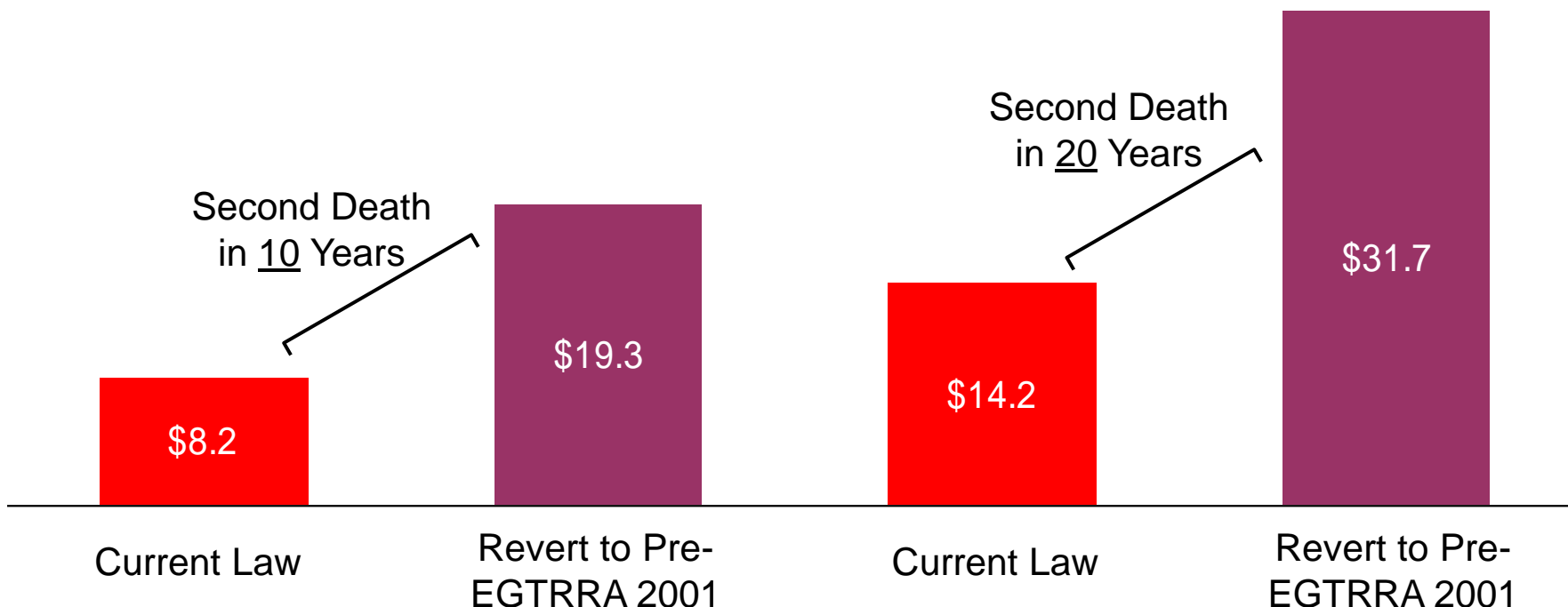
## Blended Wealth Transfer Plan: Current Life Insurance Situation

- **Husband is “uninsurable”**
- **Couple’s current life insurance situation**
  - **\$5 million single-life coverage on wife currently held in irrevocable life insurance trust (ILIT); annual premium = \$100,000**
  - **According to insurance advisor, could add up to \$5 million of coverage on wife; additional annual premium = \$235,000**
- **Total of 13 descendants, so additional premiums are within annual exclusion limits—for now**

**Key Question: Should they add to their current coverage?**

# Even Under Current Law, the Estate Tax Liability Will Be Substantial Absent Further Planning

**Median Estimated Federal Estate Tax Liability\***  
**40 / 60 Portfolio,\*\* \$25 Million Initial Value**  
**Spend \$100,000 (Real) Annually, No Life Insurance**  
**\$ Millions, Nominal**



Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 10 and 20 years, respectively. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

\*In "Current Law" scenarios, assumes median combined applicable exclusion amount (inflation-adjusted) of \$13.7M if second death occurs in Year 10, and \$19.0M if second death occurs in Year 20, and "flat" estate tax rate of 35%. In "Revert to Pre-EGTRRA 2001" scenarios, assumes combined applicable exclusion amount (nominal) of \$2M and "flat" estate tax rate of 55%.

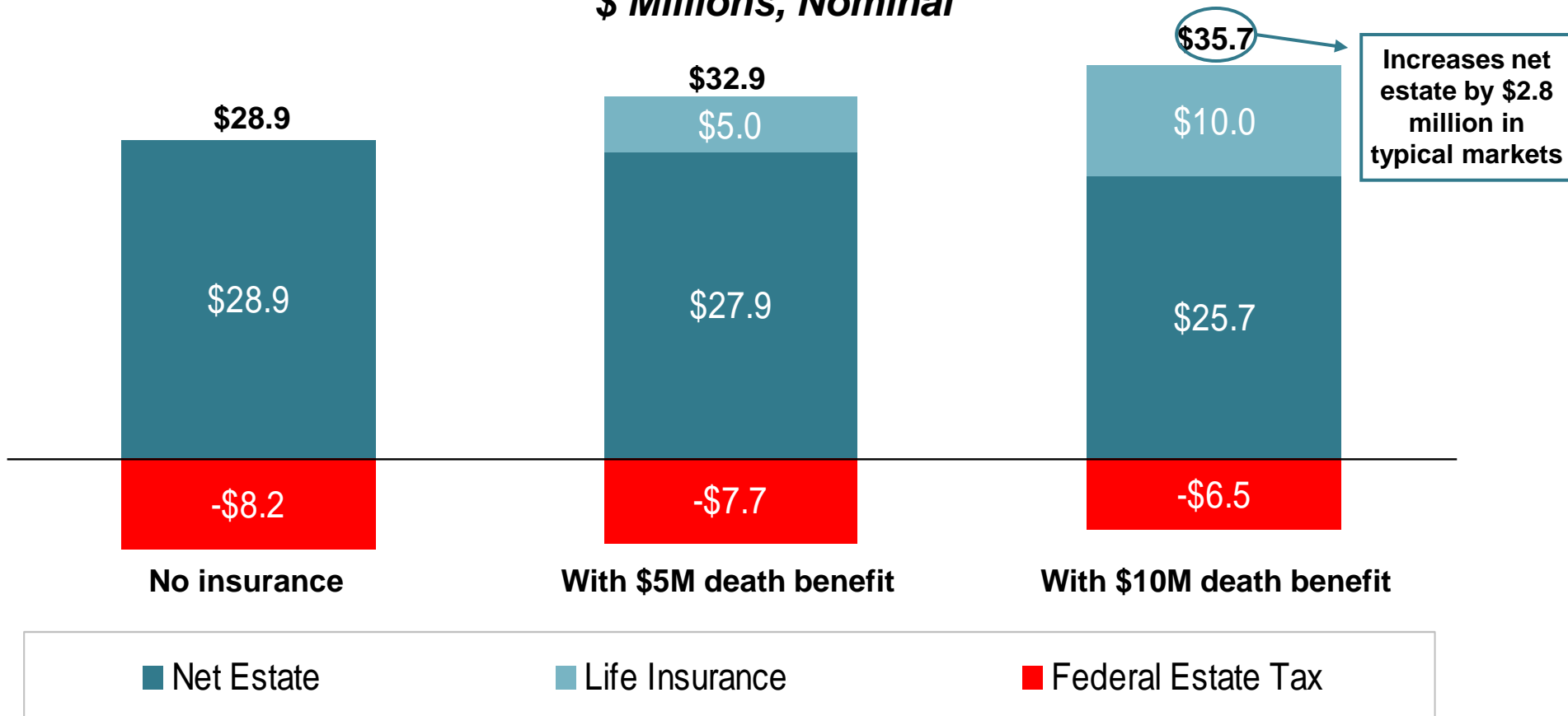
\*\*\*40/60 Portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

Source: AllianceBernstein



# If the Second Death Occurs Within 10 Years, Acquiring Additional Life Insurance Should Pay Off Handsomely . . .

**Median Wealth to Beneficiaries—10th Year  
40 / 60 Portfolio,\* Net of Estate Tax\*\*  
\$ Millions, Nominal**



Based on Bernstein's estimate of median returns for the applicable capital markets over the next 10 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

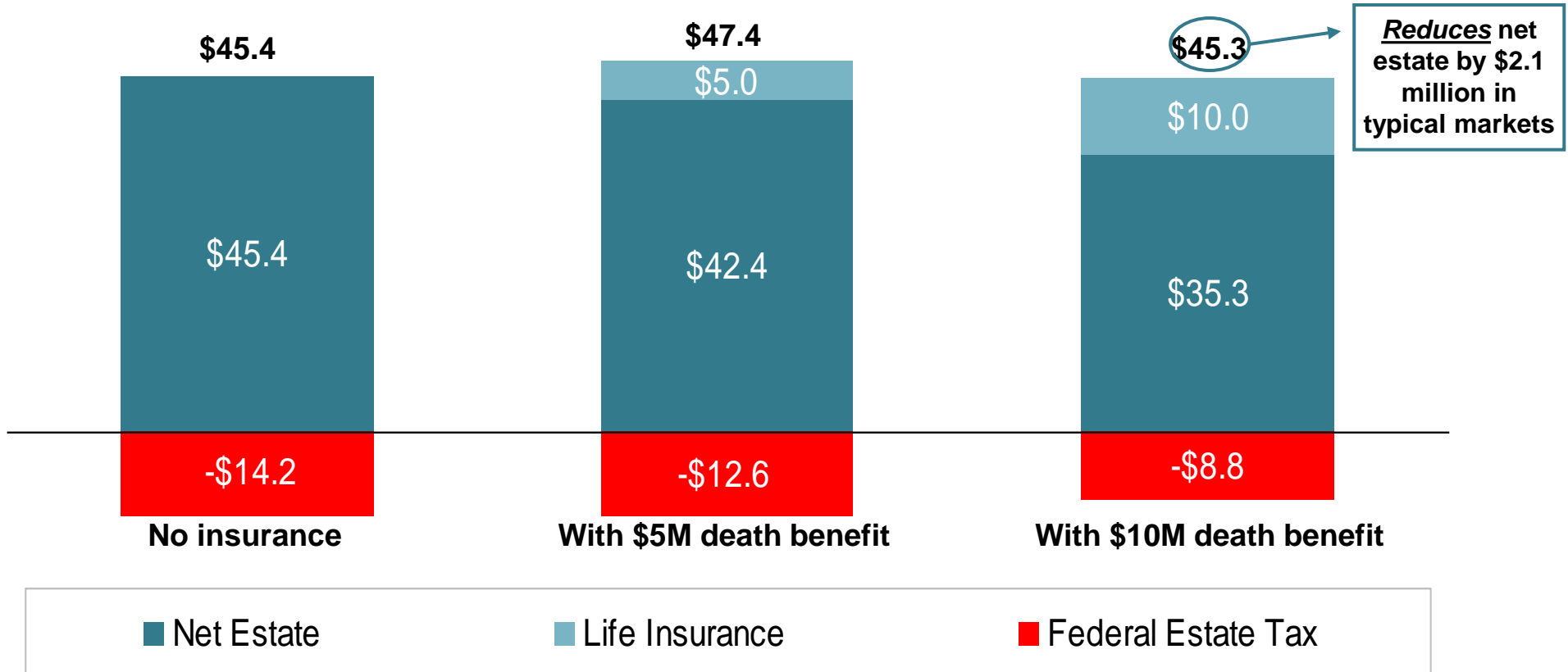
\*\*40/60 Portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

\*\*Assumes median combined applicable exclusion amount (inflation-adjusted) of \$13.7M and "flat" estate tax rate of 35%.

Source: AllianceBernstein

# ... But if the Second Death Occurs in 20 Years, Adding the Second Policy May Not Be Beneficial

**Median Wealth to Beneficiaries—20th Year**  
**40 / 60 Portfolio,\* Net of Estate Tax\*\***  
*\$ Millions, Nominal*



Based on Bernstein's estimate of median returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

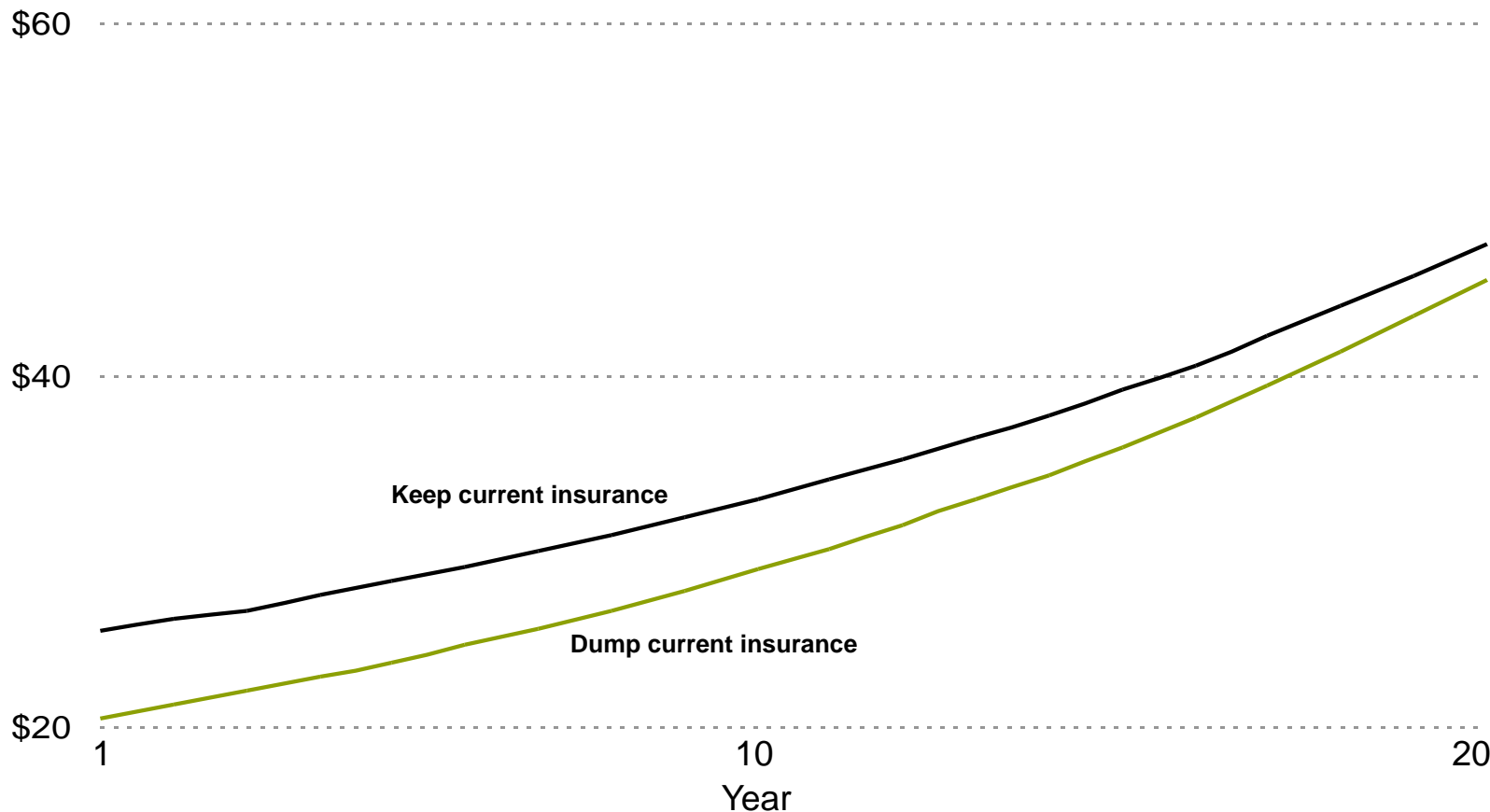
\*\*40/60 portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

\*\*Assumes median combined applicable exclusion amount (inflation-adjusted) of \$19.0M and "flat" estate tax rate of 35%.

Source: AllianceBernstein

# Clients Should Keep Their Current Life Insurance, Despite the Expense

## Median Wealth to Beneficiaries 40 / 60 Portfolio,\* Net of Estate Tax\*\* \$ Millions, Nominal



Based on Bernstein's estimate of median returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

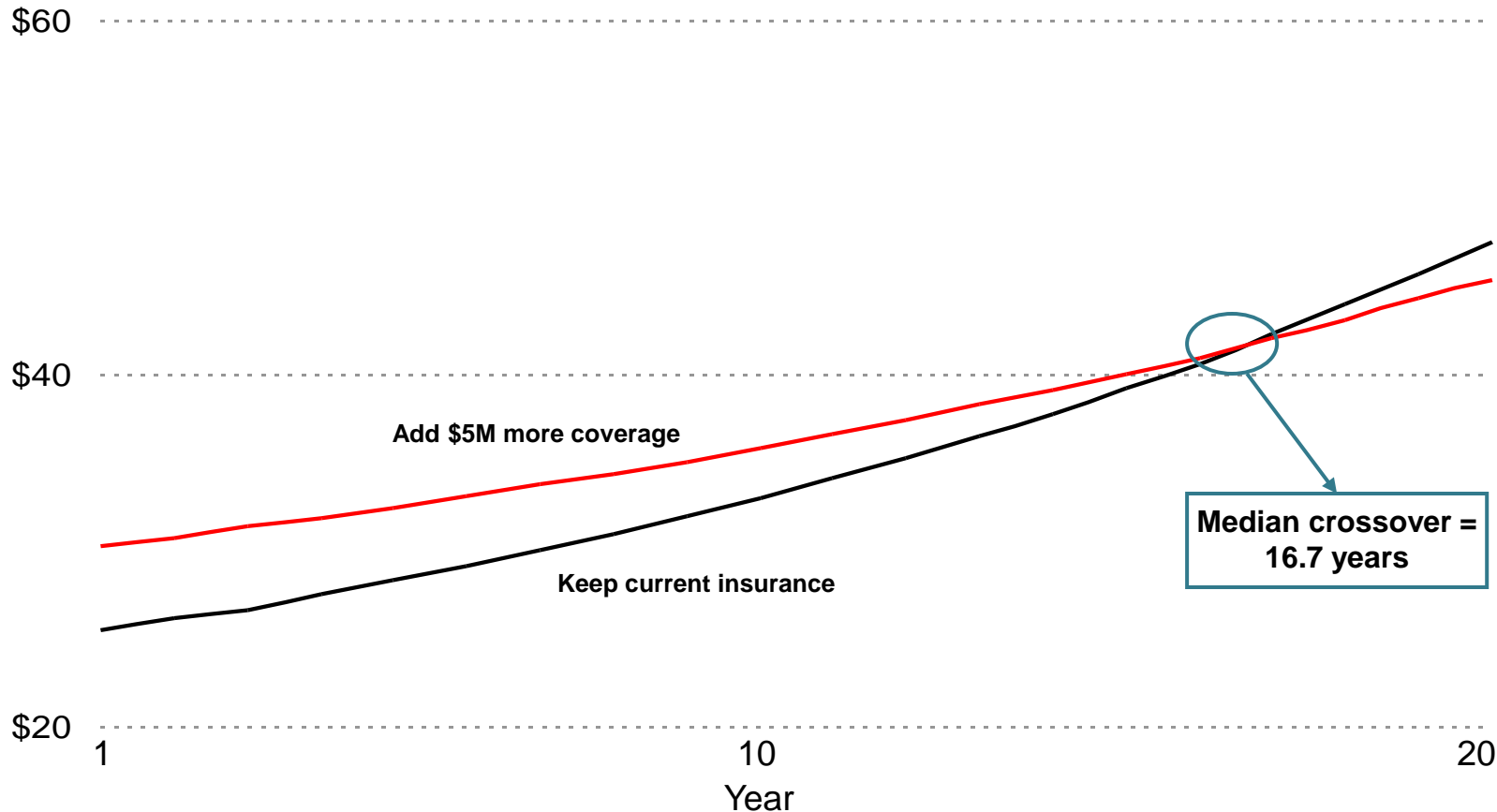
\*"40/60 portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

\*\*Assumes median combined applicable exclusion amount of \$10.24M in Year 1, adjusted annually at median inflation rate of 3.3%, and "flat" estate tax rate of 35%.

Source: AllianceBernstein

# Adding More Coverage Is Beneficial . . . But Not Indefinitely

## Median Wealth to Beneficiaries 40 / 60 Portfolio,\* Net of Estate Tax\*\* \$ Millions, Nominal



Based on Bernstein's estimate of median returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

\*\*40/60 portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

\*\*Assumes median combined applicable exclusion amount of \$10.24M in Year 1, adjusted annually at median inflation rate of 3.3%, and "flat" estate tax rate of 35%.

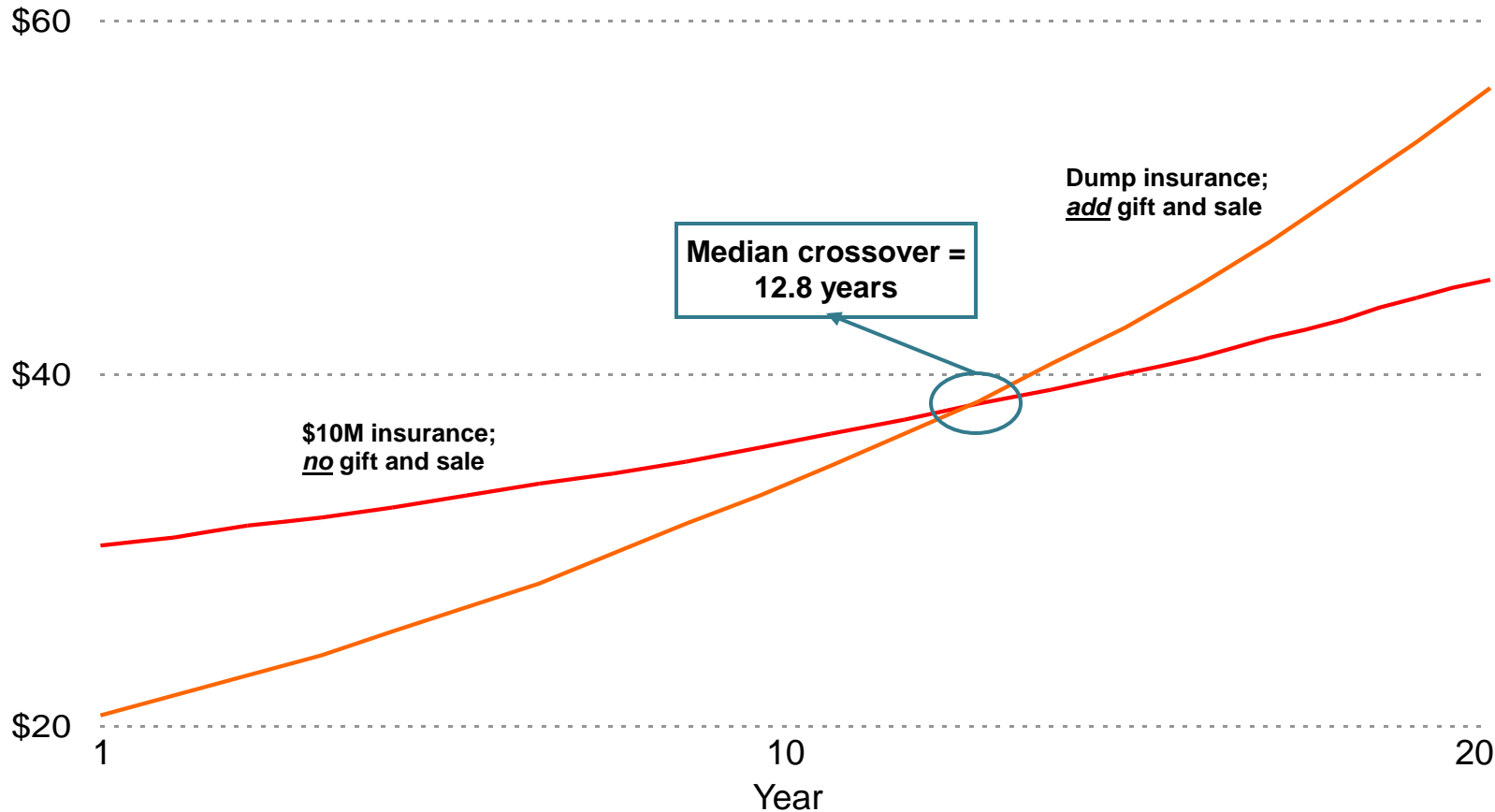
Source: AllianceBernstein

# Blended Wealth Transfer Plan: Effect of Lifetime Wealth Transfer

- **What if, in addition to (or in lieu of) buying more life insurance, the couple**
  - **Keeps their core capital of \$2.5 million;**
  - **Gives \$10.24 million of their portfolio to an irrevocable (“intentionally defective”) grantor trust;**
  - **Sells an additional \$12.26 million of their portfolio to that trust, in exchange for a nine-year promissory note that bears interest at a rate of 1.12% (February 2012 mid-term applicable federal rate)?**
- **Assume no asset allocation change in the grantor trust (40 / 60)**

# ... And Continues to Provide a Benefit for About Three More Years ...

## Median Wealth to Beneficiaries 40 / 60 Portfolio,\* Net of Estate Tax\*\* \$ Millions, Nominal



Based on Bernstein's estimate of median returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

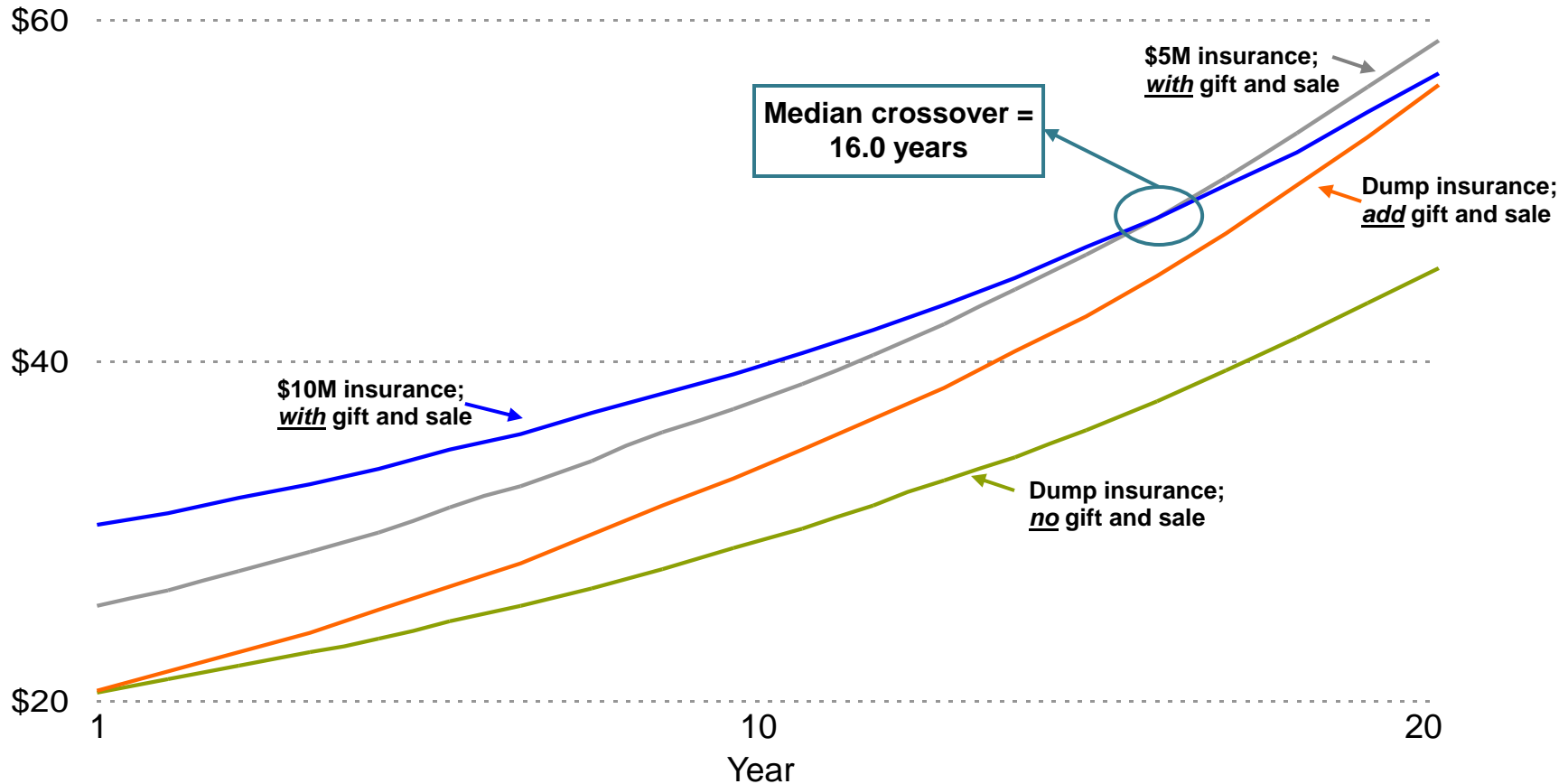
\*"40/60 portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

\*\*Assumes median combined applicable exclusion amount of \$10.24M in Year 1, adjusted annually at median inflation rate of 3.3%, and "flat" estate tax rate of 35%.

Source: AllianceBernstein

# Blending Life Insurance with a Substantial Lifetime Transfer Often Produces the Best Risk-Adjusted Result

## Median Wealth to Beneficiaries 40 / 60 Portfolio,\* Net of Estate Tax\*\* \$ Millions, Nominal



Based on Bernstein's estimate of median returns for the applicable capital markets over the next 20 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

\*"40/60 portfolio" means 40% globally diversified stocks, 60% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks.

\*\*Assumes median combined applicable exclusion amount of \$10.24M in Year 1, adjusted annually at median inflation rate of 3.3%, and "flat" estate tax rate of 35%.

Source: AllianceBernstein

## Blended Wealth Transfer Plan: Observations

- Life insurance is almost always a superior investment when the insured dies relatively young
  - Determine the “crossover” point: How long would the insured have to live for the policy to become a “drag” on the investment or estate plan?
- Blended strategies tend to produce the best result
  - Life insurance adds immediate value, but may mute estate-tax-adjusted growth over time
  - The benefits of a lifetime transfer take time to build
- Life insurance may provide additional protection (i.e., crossover may be extended) in poor markets



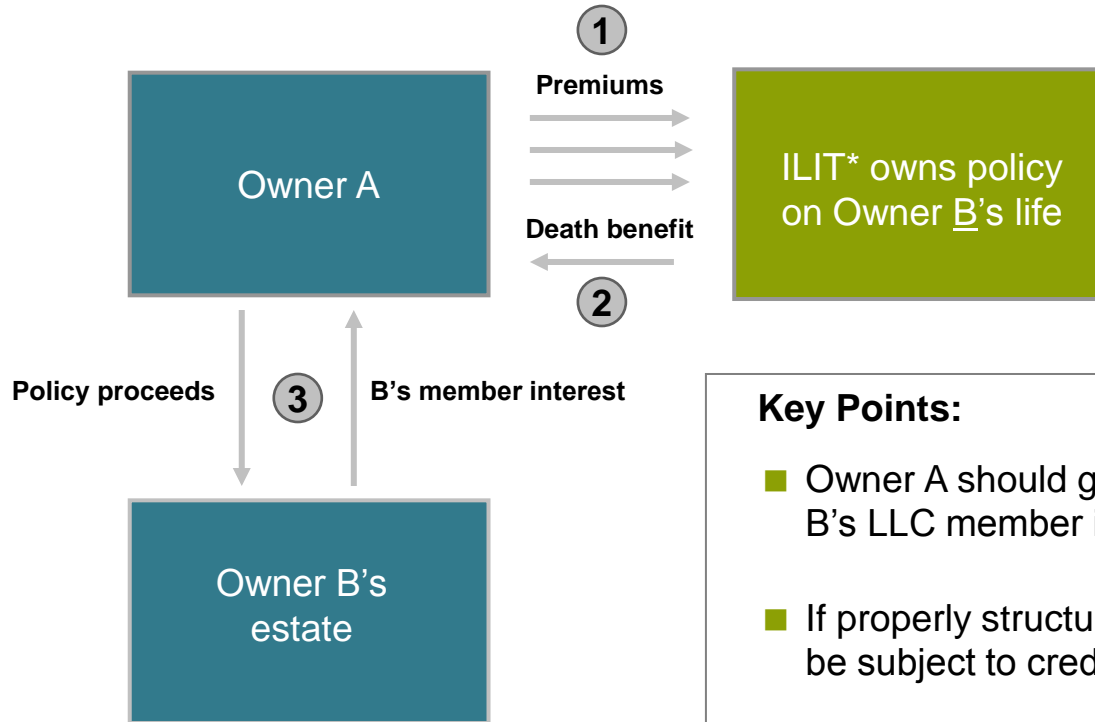
## **Case Study: Buy-Sell Agreement Policy Alternatives and Evaluation**

## Buy-Sell Agreement: Case Study Facts

- **Closely held business (LLC) is believed to be worth \$30 million as a going concern**
- **No sale of the business is contemplated**
- **Two 50 percent owners**
  - **A: 53-year-old male, preferred risk (best underwriting category)**
  - **B: 55-year-old male, standard risk (3<sup>rd</sup> best category)**
- **Buy-sell agreement provides that upon the death of one owner, the survivor will buy the decedent's LLC member interest for \$15 million**

# Where Will the Survivor's \$15 Million Purchase Price Come From?

## Financing a Cross-Purchase Buy-Sell Agreement with Life Insurance



### Key Points:

- Owner A should get a stepped-up (cost) basis in Owner B's LLC member interest
- If properly structured, death benefit proceeds should not be subject to creditors' claims or estate taxes
- Can be unwieldy if there are multiple owners—not the case here
- *Perceived inequity if there are large disparities in premiums due to age or health differences—an issue here*

\*"ILIT" means an irrevocable life insurance trust. In a typical ILIT, trust beneficiaries are given temporary powers of withdrawal (so-called "Crummey" powers) over contributions to the trust so that those contributions may qualify for the gift tax annual exclusion. The trustee of the ILIT then uses those contributions to pay annual insurance premiums. If properly structured, the death benefit proceeds of the life insurance policy or policies should not be subject to estate tax upon the death of the grantor or the insured.

# Life Insurance Policy Designs Considered

- **The insurance analyst examined six different single-life policy designs (\$15 million level death benefit) across multiple carriers**
  - **10-year term**
  - **20-year term**
  - **30-year term**
  - **Universal life (UL) with secondary no-lapse guarantee**
  - **UL with cash accumulation, no secondary guarantee**
  - **Blended whole life (i.e., whole life blended with term and paid-up additions)**

# Life Insurance Analysis Reviewed with Owners

Policy type	Annual premium Owner A	Annual premium Owner B	Total premium outlay*	Revisit in
10-year term	\$17,648	\$31,719	\$493,670	2021
20-year term	33,685	60,219	1,878,080	2031
30-year term	57,963	120,065	5,340,840	2041
UL with guarantee	126,004	200,756	14,704,200	2056**
UL without guarantee	126,004	200,756	14,050,680	2054***
Blended whole life	189,049	280,683	30,532,580	Never†

**Problem: In a typical cross-purchase arrangement, Owner A will pay premiums on Owner B's policy**

\*Assumes annual premiums are paid through the year listed in the column headed "Revisit in" on the far right-hand side of the table. Premium outlays are not adjusted for the time value of money.

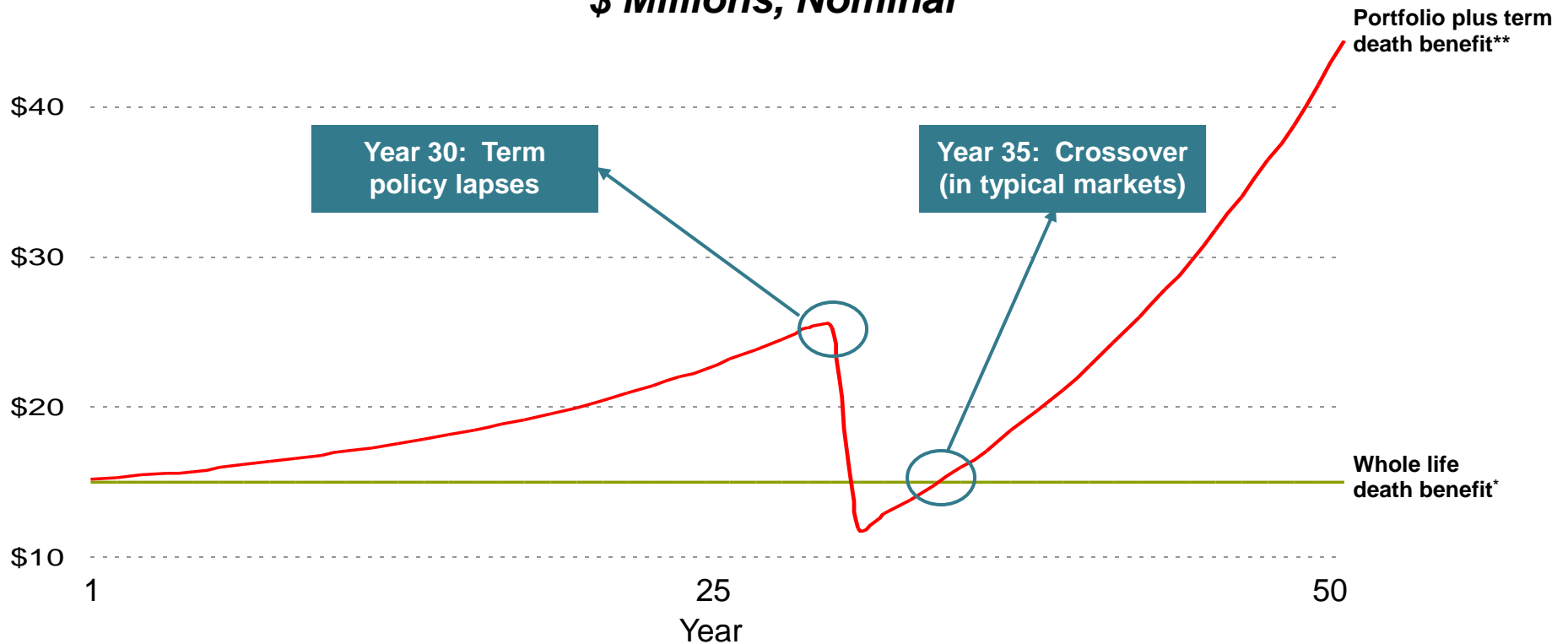
\*\*Based on secondary no-lapse guarantee through age 100.

\*\*\*As illustrated, based on current crediting rate of 5.2% and current policy expenses.

†Based on policy ending at age 120.

# Buy Term and Invest the Difference?

## Whole Life Death Benefit\* vs. Projected Portfolio Value Plus Term Death Benefit\*\* 60/40 Portfolio, After Income Taxes, Typical Markets\*\*\* \$ Millions, Nominal



Portfolio values (not policy death benefits) are based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 50 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

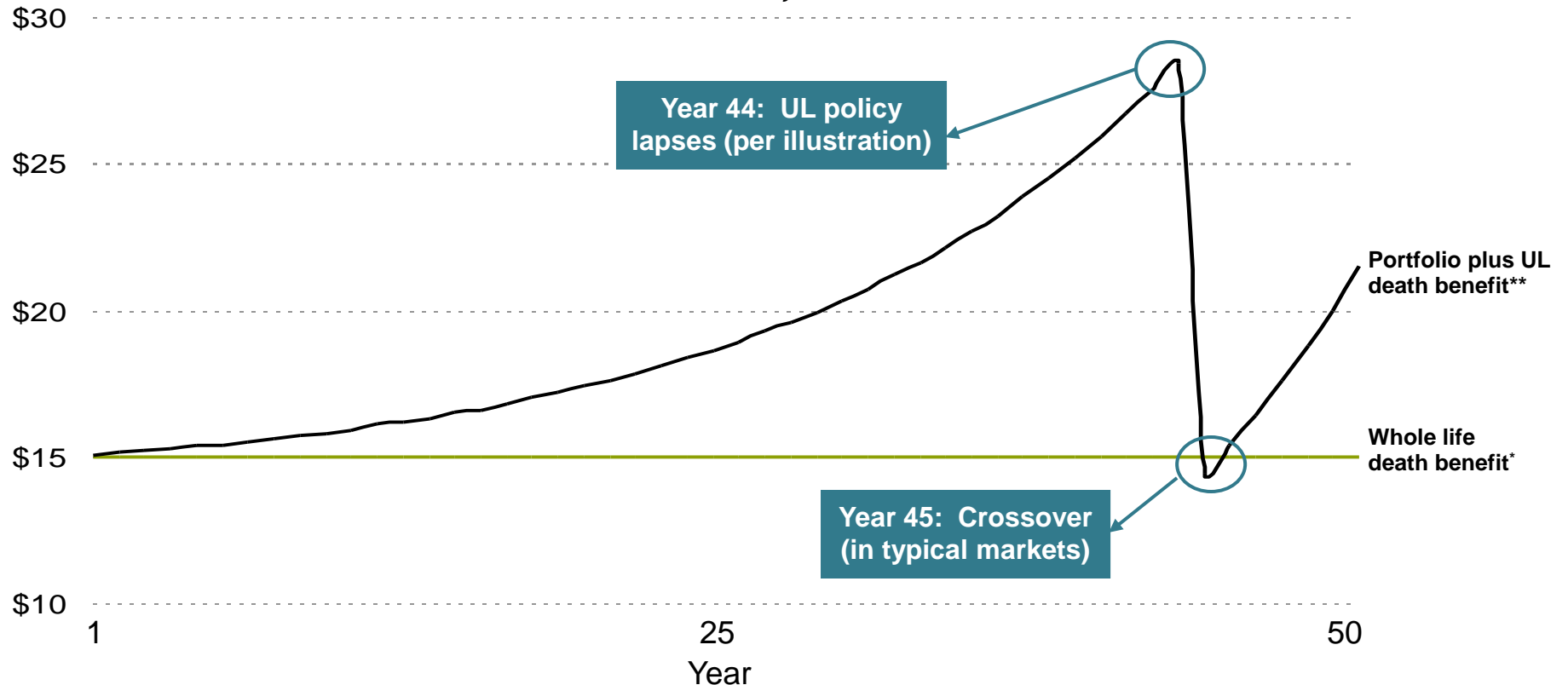
\*\*"Whole life death benefit" scenario is based upon an actual case in which a blended whole life / term life insurance policy was proposed to a healthy, 53-year-old male ("Owner A"). As illustrated, annual premium is \$189,049 and death benefit through age 115 is \$15M, increasing modestly each year thereafter until endowment at age 120.

\*\*\*"Portfolio plus term death benefit" scenario is based upon an actual case in which a 30-year term life insurance policy was proposed to Owner A, as defined in the immediately preceding footnote. As illustrated, annual premium is \$57,963 and death benefit through age 82 is \$15M. In this scenario, the difference between the annual whole life premium and the annual term premium (i.e., \$189,049 minus \$57,963 equals \$131,086) is invested each year in a portfolio of marketable securities. In years 1 through 30, the displayed value is the sum of the term death benefit and the median portfolio value calculated by Bernstein's Wealth Forecasting System; in years 31 through 50, the displayed value is the median portfolio value only.

\*\*\*\*"60/40 portfolio" means 60% globally diversified stocks, 40% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks. "Typical markets" means the median result of 10,000 trials for applicable capital markets in Bernstein's Wealth Forecasting System.

# Buy UL and Invest the Difference?

## Whole Life Death Benefit\* vs. Projected Portfolio Value Plus UL Death Benefit\*\* 60/40 Portfolio, After Income Taxes, Typical Markets\*\*\* \$ Millions, Nominal



Portfolio values (not policy death benefits) are based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 50 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

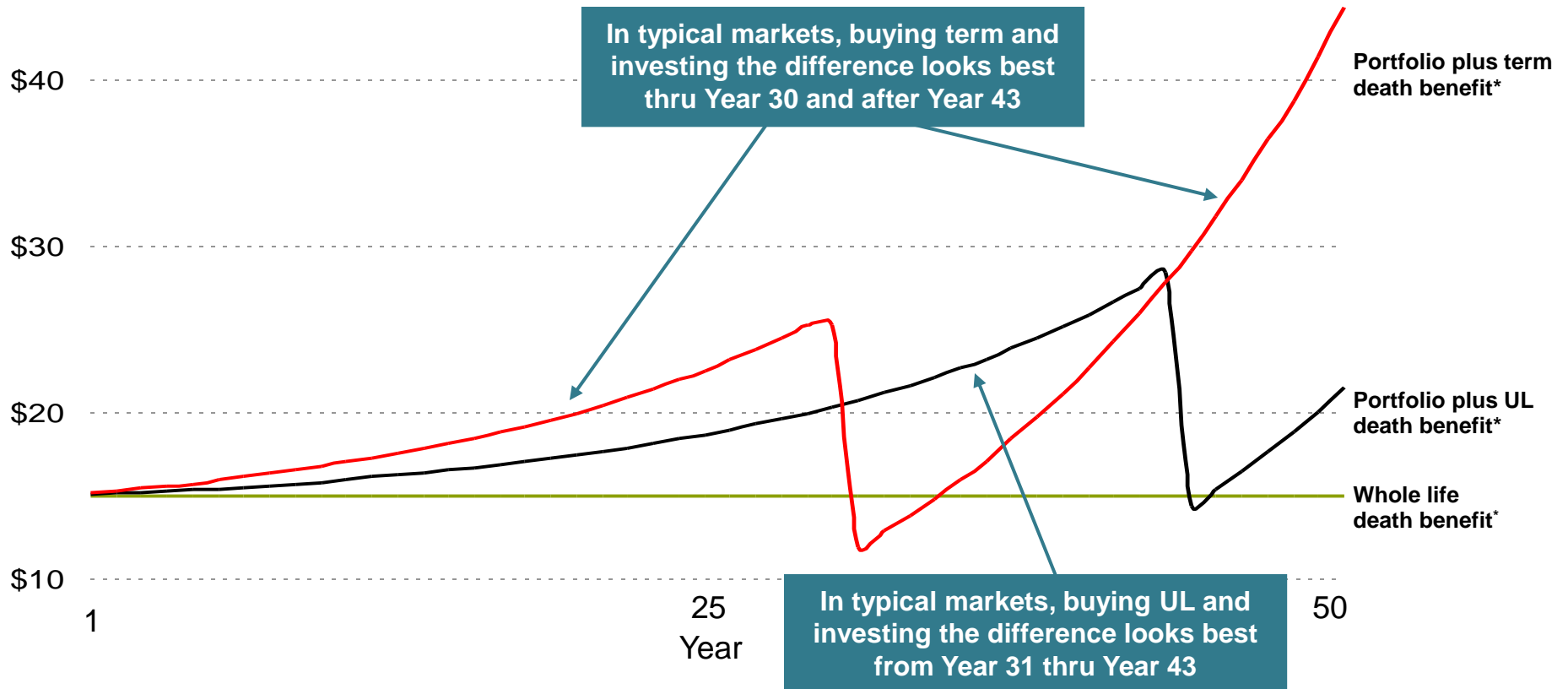
\*\*"Whole life death benefit" scenario is described in a footnote on the immediately preceding display.

\*\*\*"Portfolio plus UL death benefit" scenario is based upon an actual case in which a universal life insurance policy was proposed to a healthy, 53-year-old male ("Owner A"). As illustrated, annual premium is \$126,004 and death benefit through age 96 is \$15M. In this scenario, the difference between the annual whole life premium and the annual UL premium (i.e., \$189,049 minus \$126,004, or \$63,045) is invested each year in a portfolio of marketable securities. In years 1 through 43, the displayed value is the sum of the UL death benefit and the median portfolio value calculated by Bernstein's Wealth Forecasting System; in years 44 through 50, the displayed value is the median portfolio value only.

\*\*\*\*"60/40 portfolio" means 60% globally diversified stocks, 40% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks. "Typical markets" means the median result of 10,000 trials for applicable capital markets in Bernstein's Wealth Forecasting System.

# So Which Is Best? It Depends on Time Horizon . . .

## Whole Life vs. UL vs. Term\* 60/40 Portfolio, After Income Taxes, Typical Markets\*\* \$ Millions, Nominal



Portfolio values (not policy death benefits) are based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 50 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

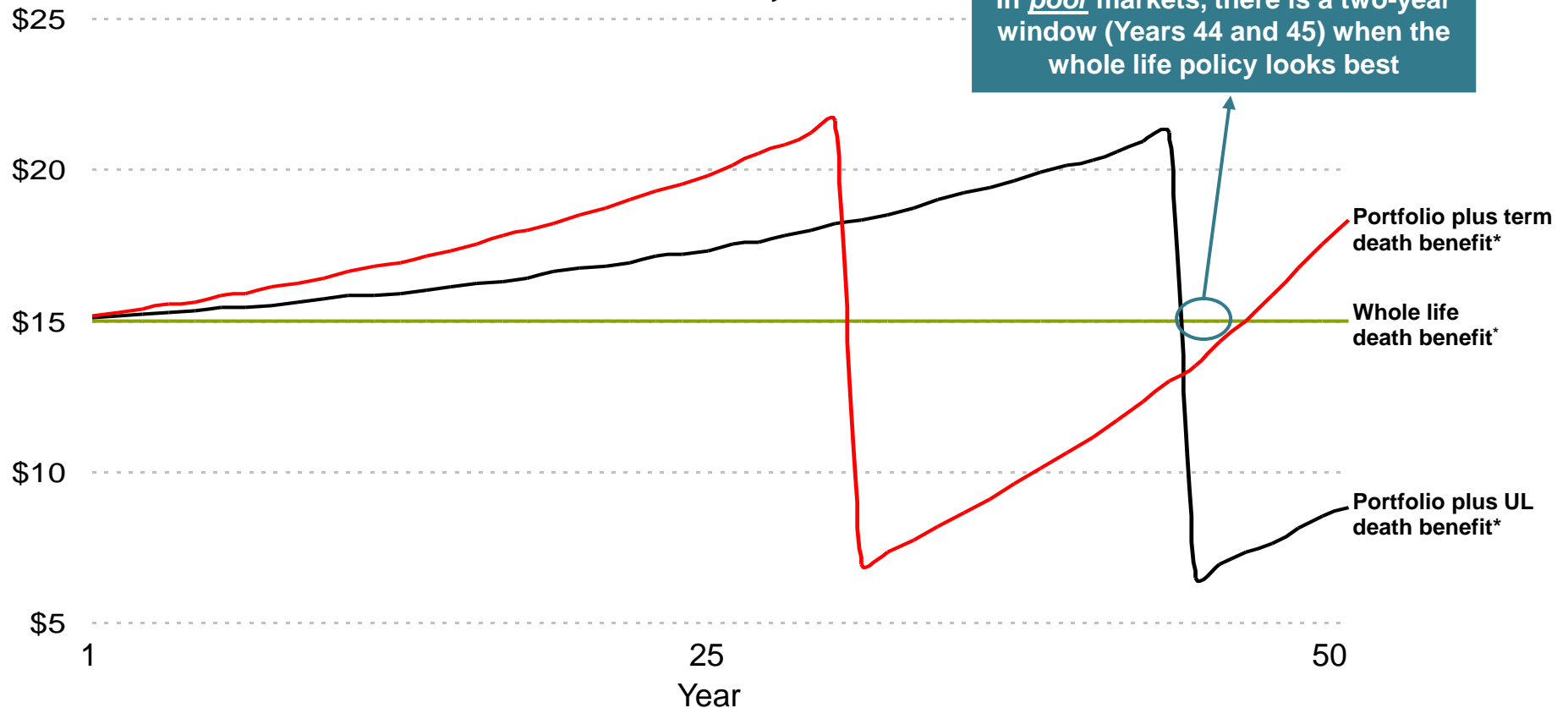
\*\*"Whole life death benefit," "portfolio plus UL death benefit," and "portfolio plus term death benefit" scenarios are described in footnotes on the immediately preceding displays.

\*\*\*"60/40 portfolio" means 60% globally diversified stocks, 40% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks. "Typical markets" means the median result of 10,000 trials for applicable capital markets in Bernstein's Wealth Forecasting System.



# So Which Is Best? It Depends on Time Horizon . . . and Capital Markets

## Whole Life vs. UL vs. Term\* 60/40 Portfolio, After Income Taxes, Poor Markets\*\* \$ Millions, Nominal



Portfolio values (not policy death benefits) are based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 50 years. Data do not represent past performance and are not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting System, for details.

\*\*"Whole life death benefit," "portfolio plus UL death benefit," and "portfolio plus term death benefit" scenarios are described in footnotes on the preceding displays.

\*\*\*"60/40 portfolio" means 60% globally diversified stocks, 40% intermediate-term municipal bonds. "Globally diversified" means 35% US value stocks, 35% US growth stocks, 25% developed international stocks, and 5% emerging market stocks. "Poor markets" means the 90<sup>th</sup> percentile result of 10,000 trials for applicable capital markets in Bernstein's Wealth Forecasting System.

## Other Buy-Sell Agreement Issues to Think About

- **Entity purchase (vs. cross-purchase) agreement**
- **Qualifying premiums for gift and GST tax annual exclusions**
  - Differences in size of families
  - Differences in annual premiums
- **Whether agreed (fixed) purchase price will be binding for estate tax purposes under Section 2703**
  - Bona fide business arrangement
  - Not an impermissible wealth transfer device
  - Comparable to arms' length arrangements

## **Case Study: Grantor Retained Annuity Trust (GRAT) Insurance**

# Term Life Insurance: GRAT Insurance

## Profile

- **70 year-old female**
- **Well above core**
- **Currently makes maximum annual exclusion gifts**
- **Interested in enhancing wealth transfer and reducing estate taxes**

# Term Life Insurance: GRAT Insurance

## Planning concept\*

- Establish grantor retained annuity trust (GRAT)
- Fund with \$10 million of marketable stocks
- 15-year annuity term

## Potential problems with this concept

- No certainty of economic success in below-average markets
- Mortality risk—if grantor dies during annuity term, all assets then held in GRAT will likely be subject to estate tax

\*Assets (Grantor and GRAT) allocated to 100% global equities (35% US value, 35% US growth, 25% developed foreign markets and 5% emerging markets). GRAT assumptions: “zeroed-out” for gift-tax purposes; initial 7520 rate of 1.4%; annuity payments grown by 20% each year.

# Proposal to Hedge Mortality Risk: Term Life Insurance to Secure Median Expected Benefit

## Median expected benefit—if grantor survives

- **Expected GRAT remainder (assuming grantor survives 15-year annuity term): \$14.7 million\***
- **Resulting estate tax savings: \$5.2 million (35% of \$14.7 million)**

## Proposed mortality hedge

- **Irrevocable life insurance trust (ILIT) funded with 15-year term life insurance policy**
- **\$49,000 annual premium\*\***
- **\$5.2 million death benefit—equal to nominal anticipated estate tax savings in median markets**

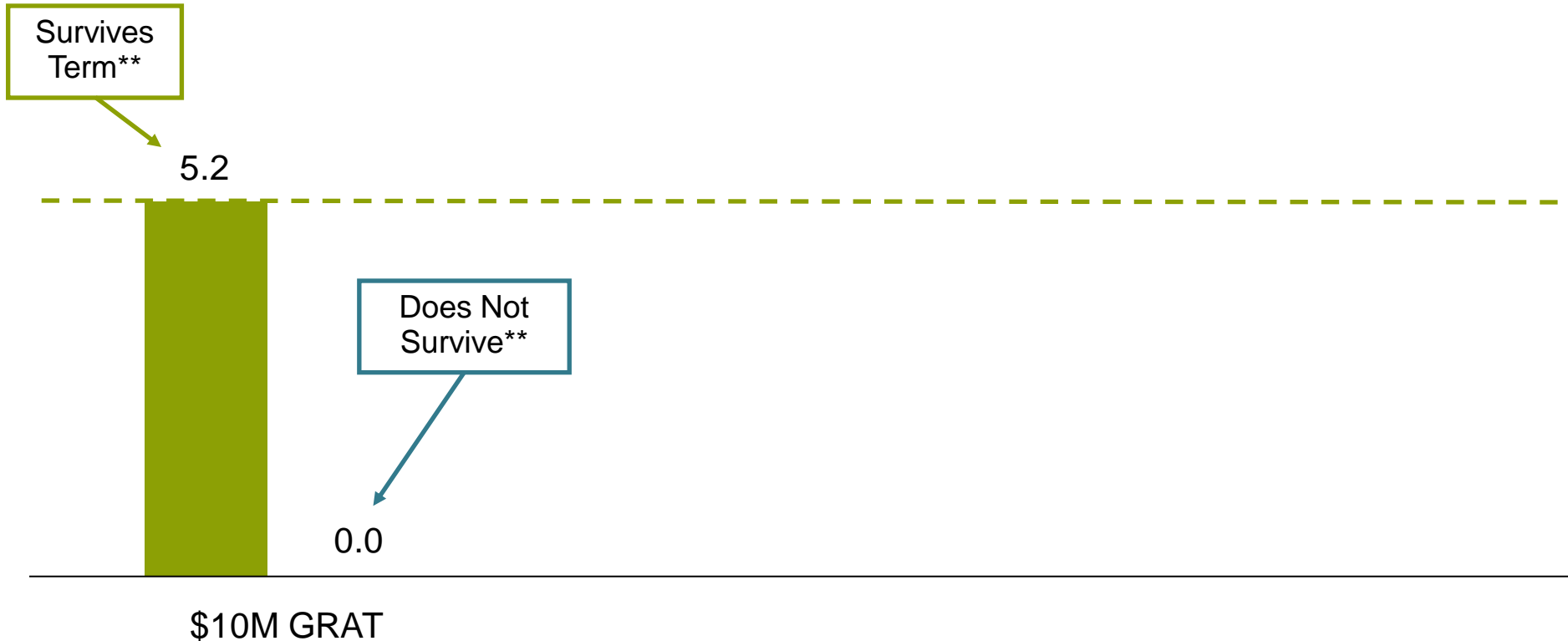
\*Median (50th percentile) outcome of 10,000 capital market trials in Bernstein's Wealth Forecasting System.

\*\*Based on quote for "Preferred Non Tobacco" from AXA Equitable (July 2012). Assumes grantor applies remaining applicable exclusion amount to premiums. Bernstein is not a legal, tax, or estate advisor. Investors should consult professionals in those disciplines before making any decisions.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over next 15 years. Data does not represent past performance and is not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting, for details.

# Success Depends in Part on Grantor Surviving Annuity Term

## Median Benefit of Strategy—Year 15\* \$ Millions



\*\*Benefit of Strategy" means increase in post-estate-tax wealth relative to no lifetime wealth transfer. Assumes "flat" 35% estate tax is imposed on grantor's portfolio at second death. "Median" means 50th percentile outcome of 10,000 capital market trials in Bernstein's Wealth Forecasting System.

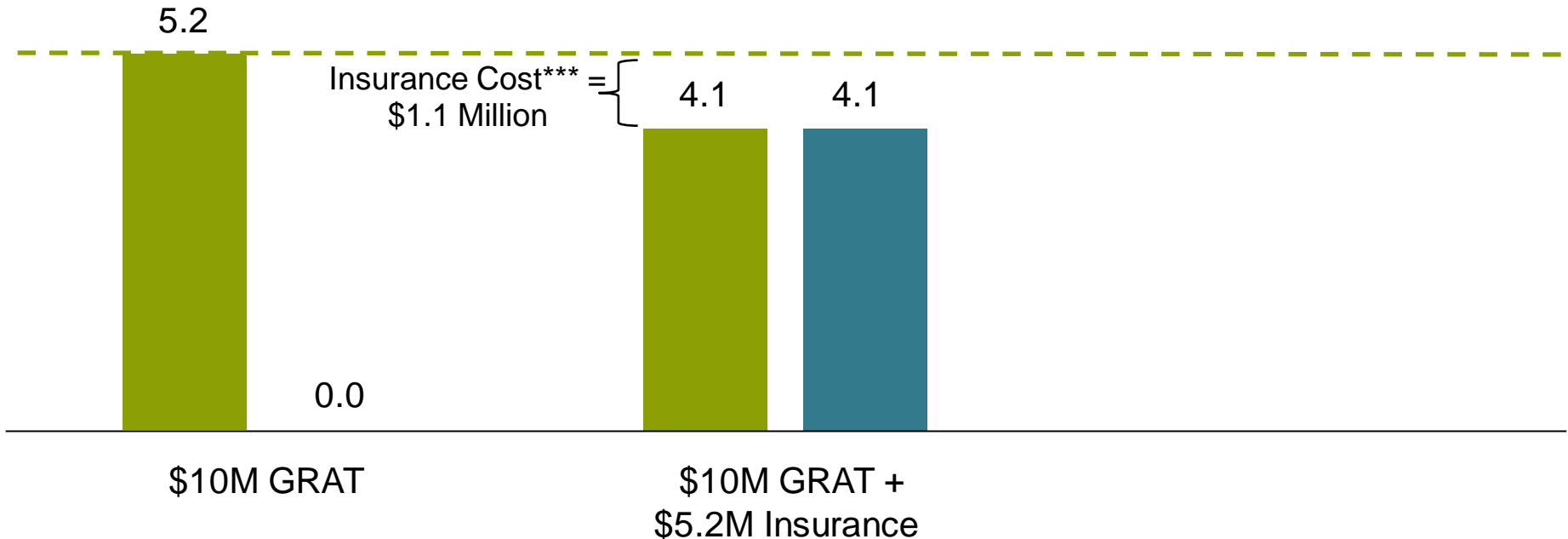
\*\*\*Survives Term" means grantor survives annuity term of GRAT; "Does Not Survive" means GRAT fails due to death of grantor.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over next 15 years. Data does not represent past performance and is not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting, for details.

# Insurance Offsets Mortality Risk, But Reduces Expected Benefit

## Median Benefit of Strategy—Year 15\* \$ Millions

■ Survives Term\*\*      ■ Does Not Survive\*\*



\*"Benefit of Strategy" means increase in post-estate-tax wealth relative to no lifetime wealth transfer. Assumes "flat" 35% estate tax is imposed on grantor's portfolio at second death. "Median" means 50th percentile outcome of 10,000 capital market trials in Bernstein's Wealth Forecasting System. In "Insurance" scenarios, portfolio is depleted by 15 years of premium payments, adjusted for estate taxes.

\*\*"Survives Term" means no life insurance death benefit is received; "Does Not Survive" means GRAT fails due to death of grantor, but death benefit is received.

\*\*\*"Insurance Cost" means depletion of grantor's portfolio due to annual premiums and forgone investment return, net of estate tax savings.

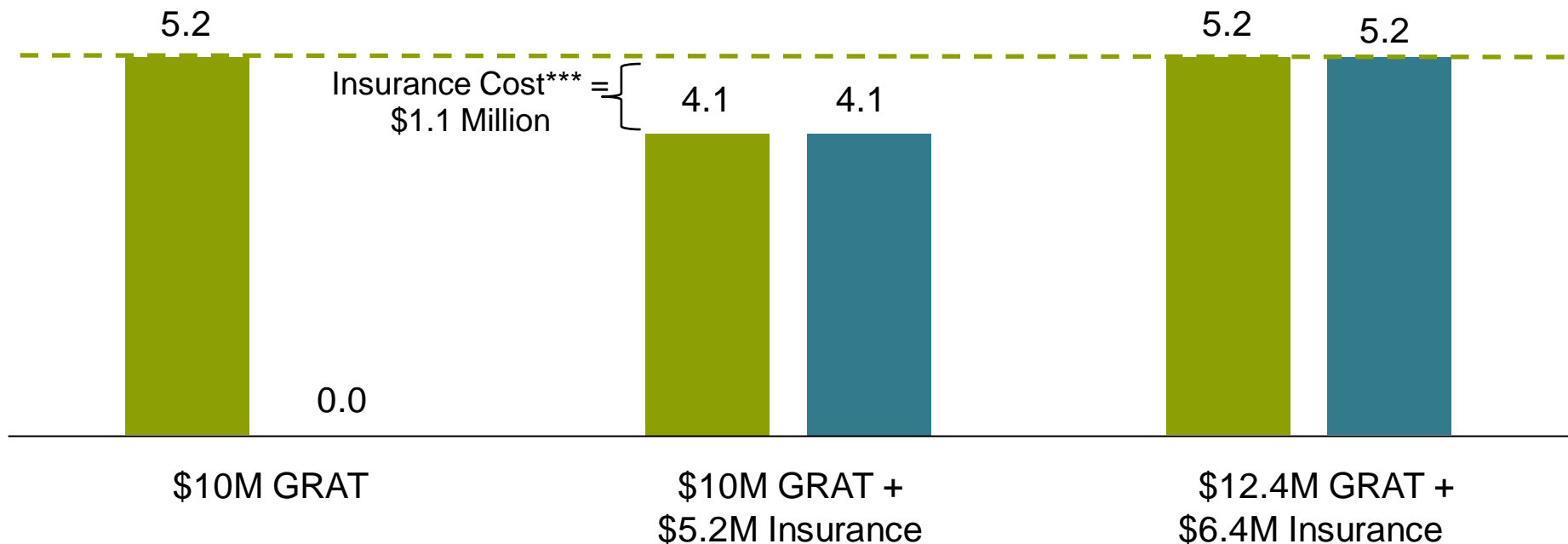
Based on Bernstein's estimates of the range of returns for the applicable capital markets over next 15 years. Data does not represent past performance and is not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting, for details.



# Strategy Can Be Scaled to Provide Same Expected Benefit Without the Mortality Risk

## Median Benefit of Strategy—Year 15\* \$ Millions

■ Survives Term\*\*      ■ Does Not Survive\*\*



\*"Benefit of Strategy" means increase in post-estate-tax wealth relative to no lifetime wealth transfer. Assumes "flat" 35% estate tax is imposed on grantor's portfolio at second death. "Median" means 50th percentile outcome of 10,000 capital market trials in Bernstein's Wealth Forecasting System. In "Insurance" scenarios, portfolio is depleted by 15 years of premium payments, adjusted for estate taxes.

\*\*"Survives Term" means no life insurance death benefit is received; "Does Not Survive" means GRAT fails due to death of grantor, but death benefit is received.

\*\*\*"Insurance Cost" means depletion of grantor's portfolio due to annual premiums and forgone investment return, net of estate tax savings.

Based on Bernstein's estimates of the range of returns for the applicable capital markets over next 15 years. Data does not represent past performance and is not a promise of actual or range of future results. See Appendix, Notes on Wealth Forecasting, for details.

# GRAT Hedged with Term Life Insurance

## Conclusions

- Term GRAT faces both economic and mortality risks
- To hedge mortality risk, term life insurance policy may be employed—but premiums may deplete grantor’s estate and reduce effectiveness of GRAT strategy
- One way to overcome this problem is to “scale up” (i.e., have grantor “overfund” GRAT, which will require a bit more life insurance to hedge additional amount at risk in strategy)
- Key analytical question: Does grantor have adequate discretionary capital to scale up?

## Some Hidden Risks to Consider

- **Inherent limitations in life insurance illustrations**
  - “Straight-line” versus stochastic modeling
- **Portfolio risk**
  - What will happen to policy dividends as carriers turn over their bond portfolios?
- **Reduction in volatility**
  - Is lower volatility a function of “conservative investing”—or portfolios that are not marked-to-market?
- **Single-issuer risk**
  - Would a prudent investor concentrate its portfolio in the securities of a single issuer?



# Appendix

# **Observations About Whole Life Insurance as a Substitute for Municipal Bonds**

# Whole Life Insurance: A Substitute for Muni Bonds?

## Profile

- 45-year-old male
- Above core, with a substantial allocation to municipal bonds

## Concern: “Municipal bonds are risky”

- Interest-rate risk: Portfolio value will fall as interest rates rise
- Default risk: Recent credit crisis has pushed municipalities to the brink of insolvency

## Planning concept: “Substitute a single-premium, whole life insurance policy from a highly rated carrier for a substantial portion of the bond portfolio”

- Higher yields
- Less volatility

# Advantages and Disadvantages of Whole Life Insurance

## Potential advantages (focusing on cash value, not death benefit)

- Higher annual yield than municipal bonds (6% dividend vs. 3% bond interest)
- Lower volatility than bond portfolio
- Low correlation to traditional capital market asset classes
- High creditworthiness of top-rated carriers

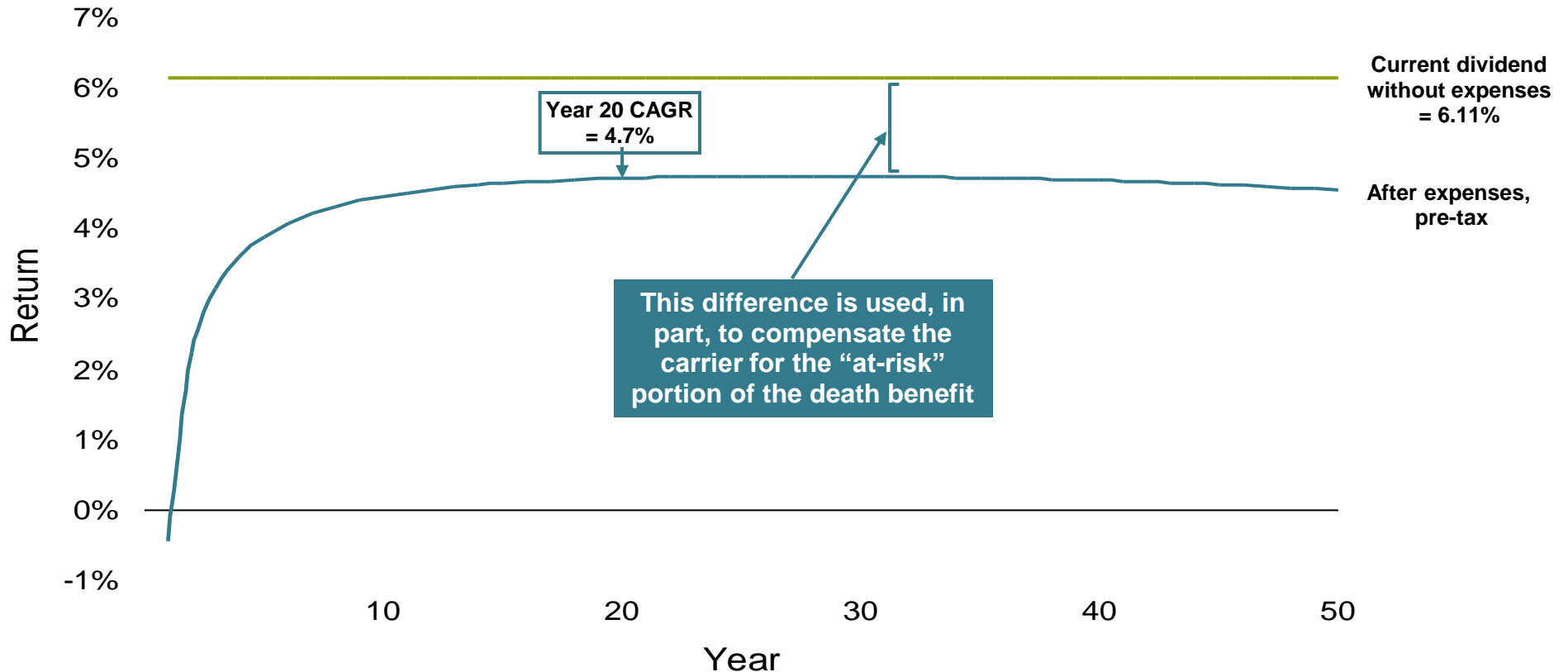
## Potential disadvantages

- Diminution of annual “yield” due to policy expenses
- Lack of tax-efficient access to cash value if policy is modified endowment contract (MEC)
- Current dividend rates may decline



# 6% Annual Dividend Sounds Attractive Until You Deduct Policy Expenses . . .

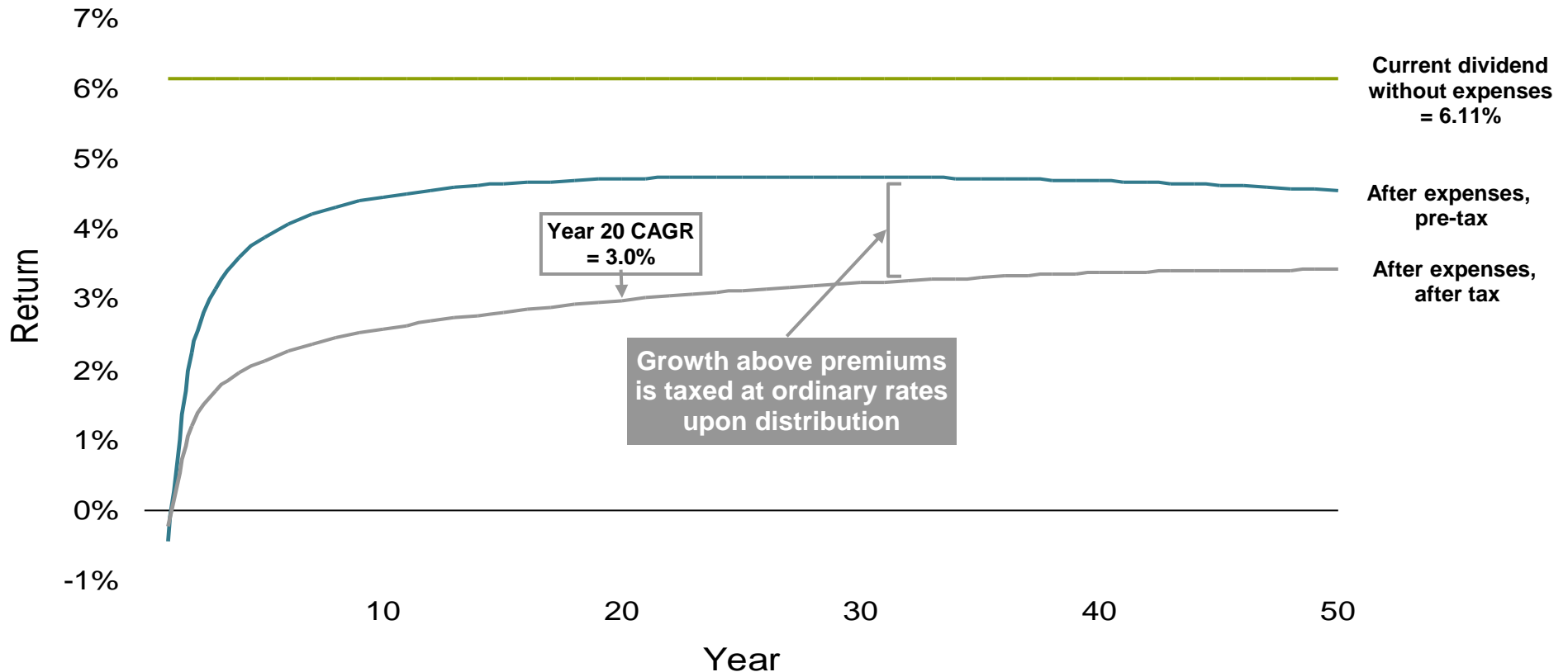
## Cash Value Net of Policy Expenses\* As Illustrated in 2011



\*Policy information is based upon actual case in which single-premium, whole life insurance policy was proposed to healthy, 45-year-old male as substitute for bonds in his investment portfolio. Initial premium is \$1M; death benefit under policy illustration is approximately \$3.4M at issuance, increasing to just over \$9.9M at end of 50 years. Policy illustration called for \$1M initial premium contribution, with additions of less than 0.5% of that amount in each of years 2 through 5. Per illustration, policy becomes modified endowment contract (MEC) in year 2. Pre-tax return reflects implied return for cash value asset, assuming current dividend rate of 6.11% and current policy expenses, per life insurance illustration. See Appendix for further details.

# ... And Income Taxes—Especially if the Policy Is a MEC

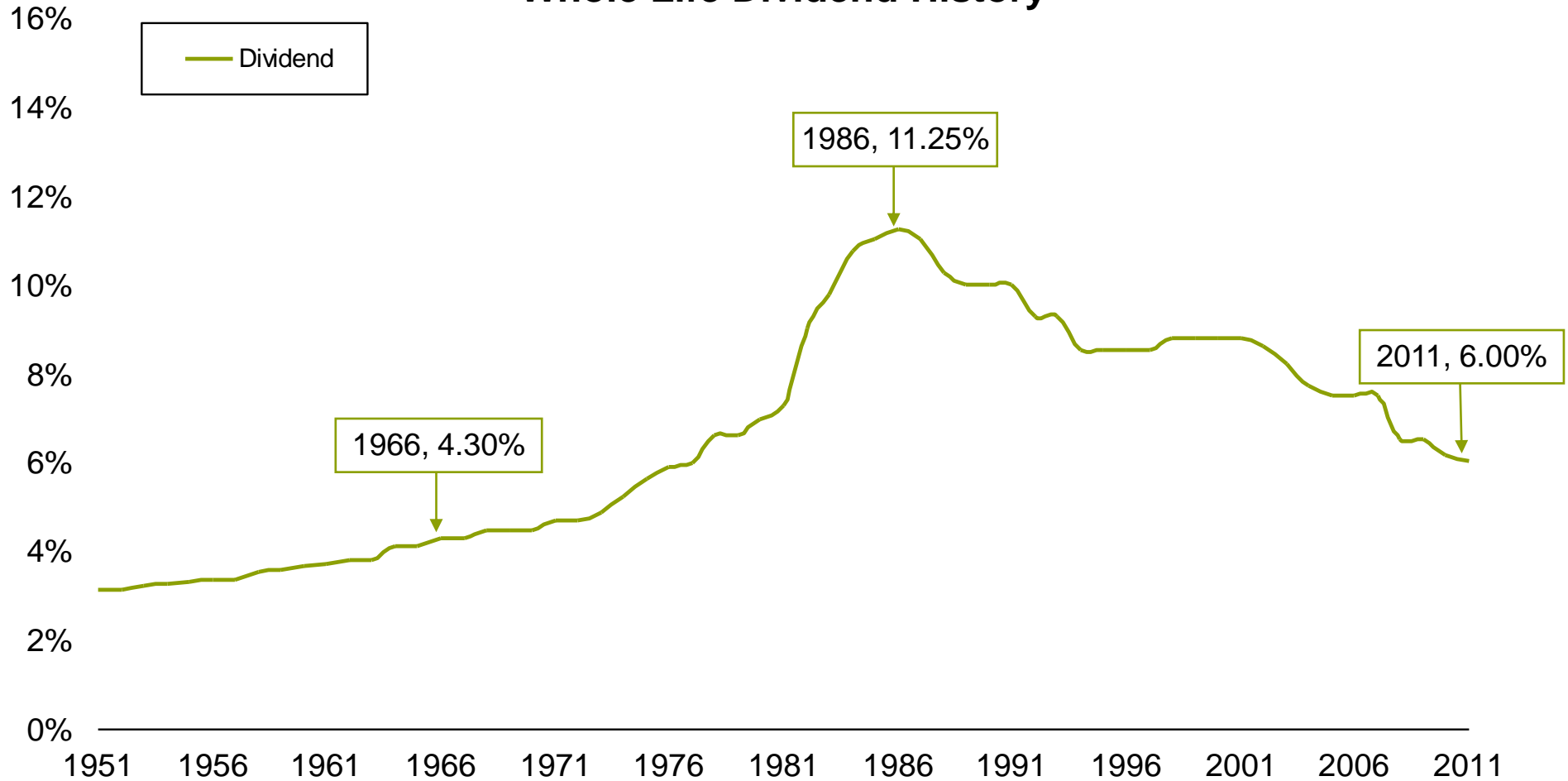
## Cash Value Net of Policy Expenses and Embedded Taxes\* As Illustrated in 2011



\*Policy information is based upon actual case in which single-premium, whole life insurance policy was proposed to healthy, 45-year-old male as substitute for bonds in his investment portfolio. Initial premium is \$1M; death benefit under policy illustration is approximately \$3.4M at issuance, increasing to just over \$9.9M at end of 50 years. Policy illustration called for \$1M initial premium contribution, with additions of less than 0.5% of that amount in each of years 2 through 5. Per illustration, policy becomes modified endowment contract (MEC) in year 2. Pre-tax return reflects implied return for cash value asset, assuming current dividend rate of 6.11% and current policy expenses, per life insurance illustration. After-tax return is net of ordinary income taxes due on growth above premiums paid. See Appendix for further details.

# Over Past Six Decades, Whole Life Dividends Have Ranged from 3% to More Than 11% . . .

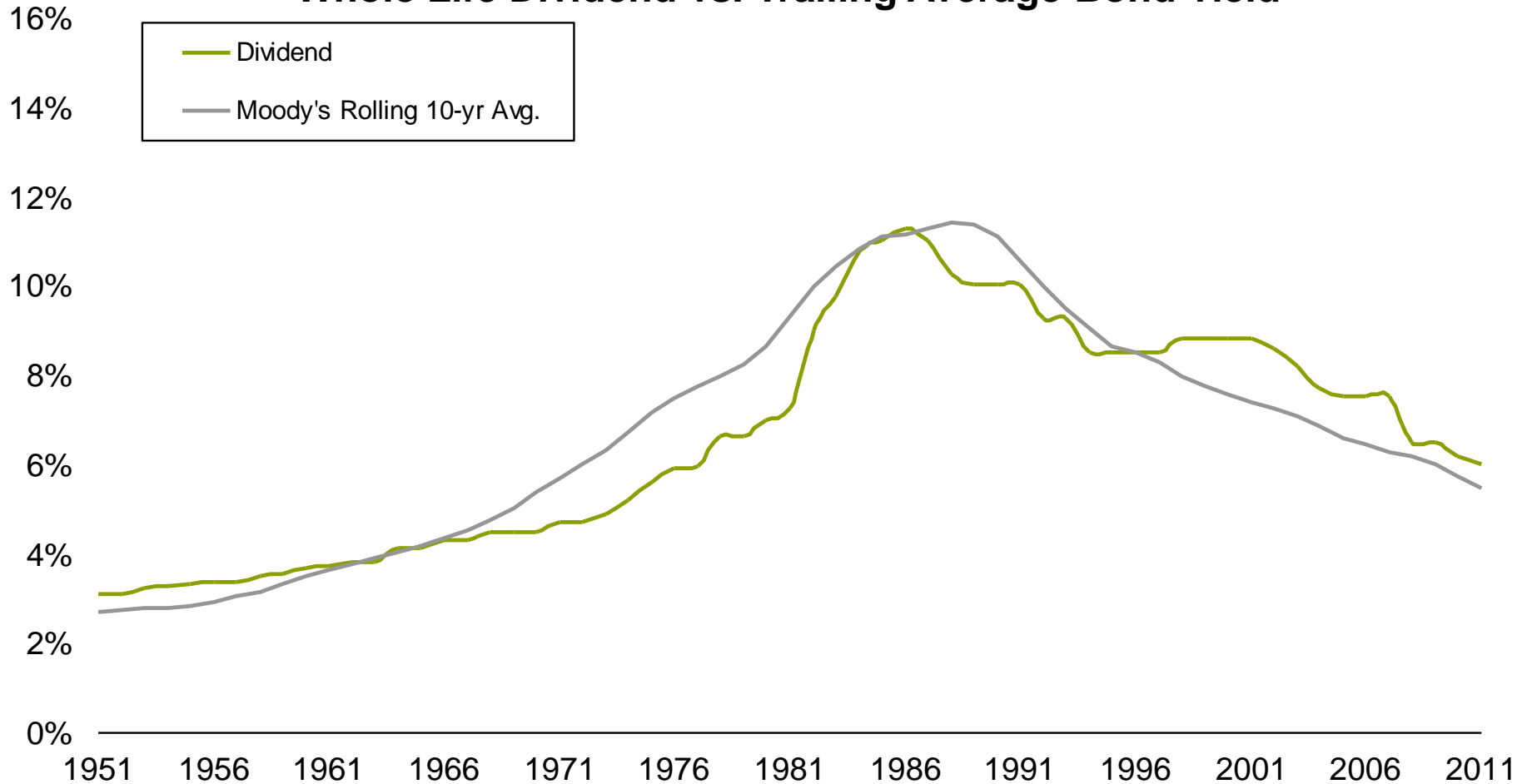
## Whole Life Dividend History\*



\*Dividend history shown is for Northwestern Mutual. Dividend histories for other major peer life insurance carriers are comparable. See Appendix for further details.

# ... And Have Closely Tracked Trailing Bond Yields

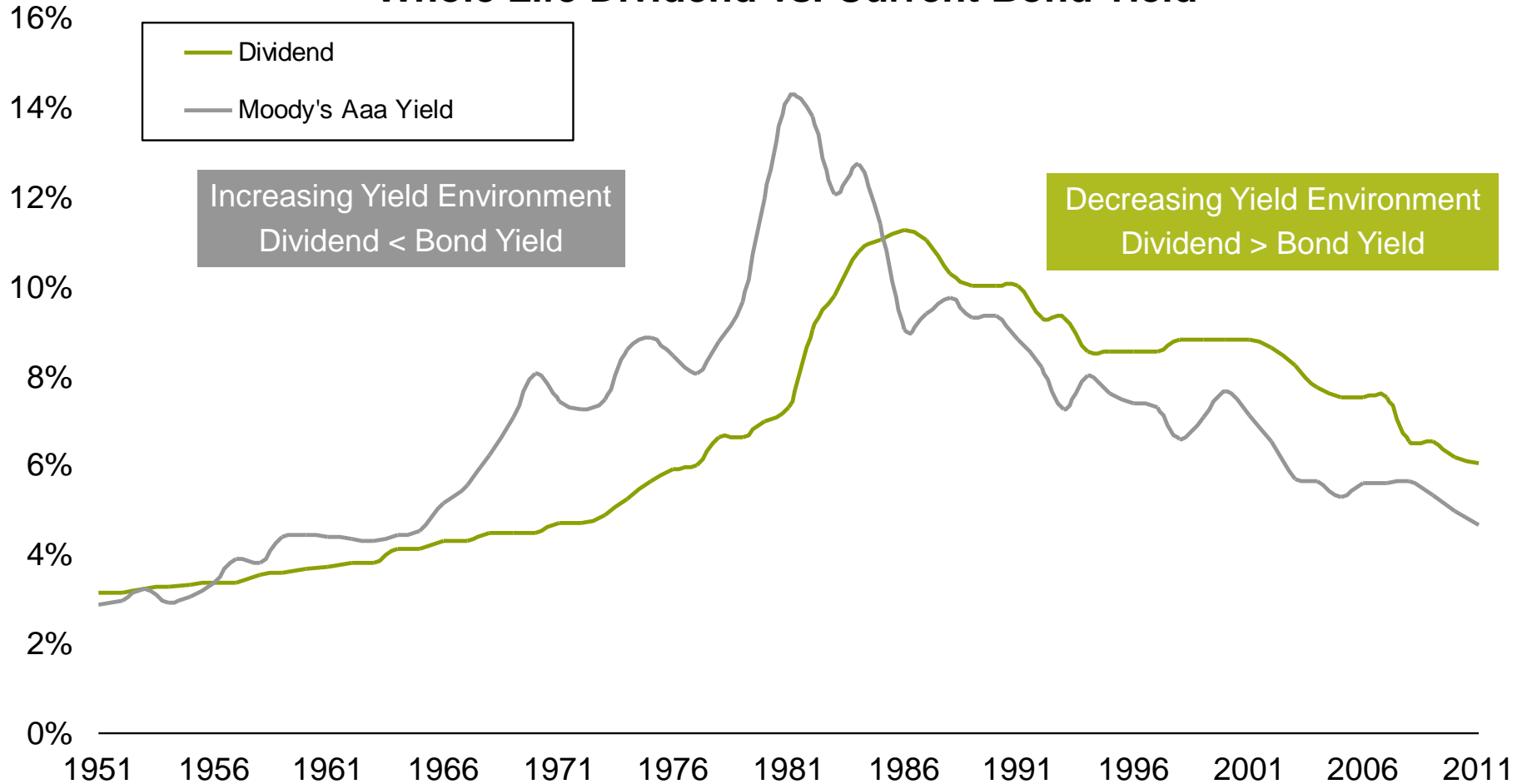
## Whole Life Dividend vs. Trailing Average Bond Yield\*



\*Dividend history shown is for Northwestern Mutual. Dividend histories for other major peer life insurance carriers are comparable. See Appendix for further details.

# When Interest Rates Rise, Whole Life Dividends Will Likely Lag

## Whole Life Dividend vs. Current Bond Yield\*



\*Dividend history shown is for Northwestern Mutual. Dividend histories for other major peer life insurance carriers are comparable. See Appendix for further details.

# Substituting Whole Life Insurance for Municipal Bonds May Not Be Prudent

## Conclusions\*

- Whole life dividends should continue to fall as long-term bonds in carriers' general account portfolios “roll off” and are replaced, in current market, with lower-yielding bonds
- But many insurance illustrations assume that current dividend and expense rates will continue indefinitely
- Some insurance proposals fail to highlight diminution in readily accessible value due to
  - Policy expenses; and
  - Potential income tax when cash value is accessed through policy loans—especially when the policy is a MEC
- On the other hand, whole life insurance dividends are largely uncorrelated to equities, and may—like municipal bonds—provide “cushion” against stock market volatility

\*See Appendix for additional analysis of insurance dividend payment histories.

# Notes on Wealth Forecasting

## 1. Purpose and Description of Wealth Forecasting Analysis

Bernstein's Wealth Forecasting Analysis<sup>SM</sup> is designed to assist investors in making long-term investment decisions regarding their allocation of investments among categories of financial assets. Our new planning tool consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: Our proprietary model, which uses our research and historical data to create a vast range of market returns, takes into account the linkages within and among the capital markets, as well as their unpredictability; and finally (4) A Probability Distribution of Outcomes: Based on the assets invested pursuant to the stated asset allocation, 90% of the estimated ranges of returns and asset values the client could expect to experience are represented within the range established by the 5th and 95th percentiles on "box and whiskers" graphs. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results or the actual probability that these results will be realized.

## 2. Rebalancing

Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, stocks, REITs and hedge funds over the period of the analysis. Where this is not sufficient, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio allocation will be maintained reasonably close to its target. In addition, in later years, there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his/her personal portfolio and entirely of stocks in his/her retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value.

## 3. Expenses and Spending Plans (Withdrawals)

All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses that will have capital gains tax implications.

# Notes on Wealth Forecasting

## 4. Modeled Asset Classes

The following assets or indexes were used in this analysis to represent the various model classes:

Asset Class	Modeled As...	Annual Turnover Rate
Intermediate-Term Diversified Municipal Bonds	AA-rated diversified municipal bonds with seven-year maturity	30%
Intermediate-Term Taxable Bonds	Taxable bonds with seven-year maturity	30%
US Value Stocks	S&P/Barra Value Index	15%
US Growth Stocks	S&P/Barra Growth Index	15%
Developed International Stocks	MSCI EAFE Unhedged	15%
Emerging Markets Stocks	MSCI Emerging Markets Index	20%

## 5. Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed on the Capital Markets Projections page at the end of these Notes. In general, two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.0%. With intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment that the volatility of fixed income assets is different for different time periods.

## 6. Technical Assumptions

Bernstein's Wealth Forecasting System is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs that summarize the current condition of the capital markets as of June 30, 2011. Therefore, the first 12-month period of simulated returns represents the period from July 1, 2011 through June 30, 2012, and not necessarily the calendar year of 2011. A description of these technical assumptions is available on request.



# Notes on Wealth Forecasting

## 7. Tax Implications

Before making any asset allocation decisions, an investor should review with his/her tax advisor the tax liabilities incurred by the different investment alternatives presented herein, including any capital gains that would be incurred as a result of liquidating all or part of his/her portfolio, retirement-plan distributions, investments in municipal or taxable bonds, etc. Bernstein does not provide tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

## 8. Income Tax Rates

Bernstein's Wealth Forecasting Analysis has used various assumptions for the income tax rates of investors in the case studies that constitute this analysis. See the assumptions in each case study (including footnotes) for details. Contact Bernstein for additional information.

The Federal Income Tax Rate is Bernstein's estimate of either the top marginal federal income tax rate or an "average" rate calculated based upon the marginal-rate schedule. The Federal Capital Gains Tax Rate is the lesser of the top marginal federal income tax rate or the current cap on capital gains for an individual or corporation, as applicable. Federal tax rates are blended with applicable state tax rates by including, among other things, federal deductions for state income and capital gains taxes. The State Tax Rate generally is Bernstein's estimate of the top marginal state income tax rate, if applicable.

The Wealth Forecasting System uses the following top marginal federal tax rates unless otherwise stated: In 2011 and 2012, a federal ordinary income tax rate of 35% and a federal capital gain tax rate of 15%. For 2013 and beyond, the maximum federal ordinary income tax rate is 43.4% and the maximum federal capital gain tax rate is 23.8%. State income taxes are imposed at a flat rate of 5%.

## 9. Estate Transfer and Taxation

The Wealth Forecasting System models the transfer of assets to children, more remote descendants, and charities, taking into account applicable wealth transfer taxes. If the analysis concerns a grantor and his or her spouse, the System assumes that only the first to die owns assets in his or her individual name and that no assets are owned jointly. It is further assumed that the couple's estate plan provides that an amount equal to the largest amount that can pass free of Federal estate tax by reason of the Federal unified credit against estate taxes (or, if desired, the largest amount that can pass without state death tax, if less) passes to a trust for the benefit of the surviving spouse and/or descendants of the first-to-die, or directly to one or more of those descendants. It is further assumed that the balance of the first-to-die's individually owned assets passes outright to the surviving spouse and that such transfer qualifies for the Federal estate tax marital deduction. Any state death taxes payable at the death of the first-to-die after 2010 are assumed to be paid from the assets otherwise passing to the surviving spouse. To the extent that this assumption results in an increase in state death taxes under any state's law, this increase is ignored. In addition, it is assumed that the surviving spouse "rolls over" into an IRA in his or her own name any assets in any retirement accounts (e.g., an IRA) owned by the first to die, and that the surviving spouse withdraws each year at least the minimum required distribution ("MRD"), if any, from that IRA. At the survivor's death, all applicable wealth transfer taxes are paid, taking into account any deductions to which the survivor's estate may be entitled for gifts to charity and/or (after 2010) the payment of state death taxes. The balance of the survivor's individually-owned assets passes to descendants and/or charities and/or trusts for their benefit. The survivor's retirement accounts (if any) pass to descendants and/or charities. To the extent that a retirement account passes to more than one individual beneficiary, it is assumed that separate accounts are established for each beneficiary and that each takes at least the MRD each year from the account. In all cases, it is assumed that all expenses are paid from an individual's taxable accounts rather than his or her retirement accounts to the maximum extent possible.

# Notes on Wealth Forecasting

## 10. Taxable (Nongrantor) Trust

The Taxable (Nongrantor) Trust is modeled as an irrevocable tax-planning or estate-planning vehicle with one or more current beneficiaries and one or more remainder beneficiaries. Annual distributions to the current beneficiaries may be structured in a number of different ways, including 1) an amount or a percentage of fiduciary accounting income (FAI) (which may be defined to include some or all realized capital gains); 2) FAI plus some principal, expressed either as a percentage of trust assets or as a dollar amount; 3) An annuity, or fixed dollar amount, which may be increased annually by inflation, or by a fixed percentage; 4) A unitrust, or annual payment of a percentage of trust assets, based on the trust's value at the beginning of the year, or average over multiple years; or 5) any combination of the above four payout methods. The trust will pay income taxes on retained income and will receive an income distribution deduction for income paid to the current beneficiaries. Capital gains may be taxed in one of three ways, as directed: 1) taxed entirely to the trust; 2) taxed to the current beneficiaries to the extent the distributions exceed traditional income; or 3) taxed to the current beneficiaries on a pro rata basis with traditional income.

## 11. Intentionally Defective Grantor Trusts (IDGTs)

The Intentionally Defective Grantor Trust (IDGT) is modeled as an irrevocable trust whose assets are treated as the grantor's for income tax purposes, but not for gift or estate tax purposes. Some income- and transfer-tax consequences associated with transfers to and the operation of an IDGT remain uncertain, and the strategy may be subject to challenge by the IRS. Hence, this technique requires substantial guidance from tax and legal advisors. The grantor may give assets to the trust, which will require using gift tax exemptions or exclusions, or paying gift taxes. The IDGT is modeled with one or more current beneficiaries, and one or more remainder beneficiaries. Distributions to the current beneficiaries are not required, but the system permits the user to structure annual distributions in a number of different ways, including 1) an amount or a percentage of fiduciary accounting income (FAI) (which may be defined to include some or all realized capital gains); 2) FAI plus some principal, expressed either as a percentage of trust assets or as a dollar amount; 3) An annuity, or fixed dollar amount, which may be increased annually by inflation, or by a fixed percentage; 4) A unitrust, or annual payment of a percentage of trust assets, based on the trust's value at the beginning of the year, or average over multiple years; or 5) any combination of the above four payout methods. Because the IDGT is modeled as a grantor trust, the system calculates all taxes on income and realized capital gains that occur in the IDGT portfolio each year, based on the grantor's tax rates and other income, and pays them from the grantor's personal portfolio. The IDGT may continue for the duration of the analysis, or the trust assets may be distributed in cash or in kind at a specific point in time or periodically to (1) a non-modeled recipient, (2) a taxable trust, or (3) a taxable portfolio for someone other than the grantor. If applicable, an installment sale to an IDGT may be modeled as a user-entered initial 'seed' gift followed by a sale of additional assets to the trust. The system will use one of two methods to repay the value of the sale assets plus interest (less any user-specified discount to the grantor): 1) user-defined payback schedule, or 2) annual interest-only payments at the applicable federal rate (AFR) appropriate for the month of sale and the term of the installment note, with a balloon payment of principal plus any unpaid interest at the end of the specified term.

# Notes on Wealth Forecasting System

## 12. Capital Markets Projections (blending and buy-sell agreement case studies)

	Median 10-Year Growth Rate	Mean Annual Return	Mean Annual Income	One-Year Volatility	10-Year Annual Equivalent Volatility
Int.-Term Diversified Municipal Bonds	2.4	2.6	2.7	4.7	2.8
US Value Stocks	8.5	10.2	3.6	23.3	16.0
US Growth Stocks	7.8	10.0	2.4	26.9	17.8
Developed International Stocks	9.1	11.3	4.3	26.4	17.4
Emerging Markets Stocks	7.1	11.6	3.8	39.4	27.9
Inflation	3.2	3.5	N/A	1.9	6.2

Based on 10,000 simulated trials each consisting of 10-year periods. Some case studies in this presentation were modeled for periods in excess of 10 years. Contact Bernstein for additional information.

Reflects Bernstein's estimates and the capital market conditions of September 30, 2011.

**Does not represent any past performance and is not a guarantee of any future specific risk levels or returns or any specific range of risk levels or returns.**

# Notes on Wealth Forecasting System

## 13. Capital Markets Projections (GRAT insurance case study)

	Median 50-Year Growth Rate	Mean Annual Return	Mean Annual Income	One-Year Volatility	50-Year Annual Equivalent Volatility
Int.-Term Diversified Municipal Bonds	3.9	4.2	4.1	3.7	11.0
Int.-Term Taxable Bonds	5.1	5.5	6.5	4.5	13.8
U.S. Value Stocks	9.2	11.0	4.6	15.8	26.0
U.S. Growth Stocks	8.8	11.1	3.2	18.2	28.0
Diversified Int'l Stocks - Unhedged	9.5	11.9	4.3	17.9	27.0
Emerging Markets Stocks	7.8	12.0	4.8	26.6	33.7
Inflation	3.4	3.7	N/A	1.1	12.6

Based on 10,000 simulated trials each consisting of 50-year periods. Some case studies in this presentation were modeled for periods shorter than 50 years. Contact Bernstein for additional information.

Reflects Bernstein's estimates and the capital market conditions of March 31, 2012.

**Does not represent any past performance and is not a guarantee of any future specific risk levels or returns or any specific range of risk levels or returns.**

