The WRMarketplace is created exclusively for AALU members by experts at Baker Hostetler LLP and the AALU staff, led by **Jonathan M. Forster, Partner, Rebecca S. Manicone, Partner, and Carmela T. Montesano, Partne**r. WR Marketplace #19-19 was written by **Jonathan M. Forster, Partner, John F. DeStefano, Associate, and Jennifer M. Smith, Counsel, BakerHostetler.**

The AALU WR Newswire and WR Marketplace are published by the AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

Thursday, October 24, 2019 **WRM#19-19**

TOPIC: Legacy Management: A Fresh Look at an Age-Old Business.

MARKET TREND: With the increasing sophistication of the investment markets, ever-changing economic conditions, and uncertainty regarding future tax laws, individuals and advisors must think differently about their approach to tax and legacy planning.

SYNOPSIS: As family wealth often fails to travel beyond two generations, it seems arguable that the traditional estate planning model, which is largely defined by episodic services, minimal financial analysis, and limited client contact post-implementation, no longer meets a successful family's legacy planning needs. Legacy management is a different approach. It seeks to provide families with a long-range (rather than episodic) planning continuum involving the outcome driven and proactive management of a family's global legacy plan through:
(1) collaboration of the family's entire advisory team; (2) extensive quantitative analyses of the family's net worth, expenditures, tax exposure, and liquidity needs; (3) development of a post-execution maintenance plan for administration and monitoring; and (4) regular benchmarking and evaluation of the plan's overall performance as reviewed annually by the family and advisory team.

TAKE AWAYS: While traditional estate plans may cost less, the value added with a comprehensive legacy management approach generally exceeds its marginally higher expense. Proactive management supported by a cooperative multi-disciplinary team helps families see

what is on the horizon and efficiently navigate changes. Professional services rendered to implement and maintain a plan also eliminate many costly issues that routinely emerge when clients use a less sophisticated or "DIY" approach. Regular interactions with the family to review performance also offer a platform for educating descendants about preserving and growing the family's legacy, while providing advisors with the opportunity to counsel multiple generations of family members, strengthening client relationships over the years.

Remarkably, 70% of wealthy families fail to transfer wealth beyond their children. Why? Because the typical approaches to transferring and maintaining a family legacy often do not work. Here is what you can do about it.

WHAT FAMILIES WANT

Most successful families are principally concerned about maintaining their lifestyle, providing some level of benefit to their children and grandchildren without over-indulging them, and creating a social and fiscally responsible legacy. In financial terms, these concerns translate into a desire to clearly understand:

- What do the parents need to maintain their lifestyle (their "**lifestyle capital**")?
- What can they afford to give away now as part of their legacy plan (their "**legacy capital**")?
- How much should their children receive, given their needs and desired goals (e.g., education, health care, retirement), and how/when should they learn of and have access to these assets?
- How can the family achieve other important and desirable goals (such as philanthropic endeavors or providing resources for extended family members)?
- How can the family preserve their legacy over the long-term?

THE TRADITIONAL APPROACH - ESTATE PLANNING

What Families Get. The traditional estate planning model is largely defined by episodic services, minimal financial analysis, and limited client contact post-implementation. Ordinarily, the client relationship and estate plan are forged during a fairly brief office meeting focused on asset distribution and estate taxes, with little understanding of the family's composition or dynamics. Estate tax planning recommendations are often based on the family's own ballpark estimate of net worth; rarely is a *detailed* net worth statement of assets and liabilities sought or referenced. Families typically make decisions off the cuff, with limited, if any, interaction with the family's other advisors to coordinate or review the potential impact of the proposed plan. The document signing ceremony concludes the transaction and the relationship. Families receive a binder of executed documents along with an instructional memorandum for them to follow *on their own.* There is generally minimal to no contact with the family's attorney after signing.

Cost vs. Value. Families focused on minimizing expenses may find this traditional model appealing because of its seemingly lower *initial* cost. Other than document preparation, much of the work is converted into a "DIY" project for the family. Unfortunately, this approach often reduces the estate plan's chance for long-term success due to a lack of active management post-signing, resulting in missed planning opportunities and latent tax issues that the family must scramble to fix years later (usually at a higher cost).

A DIFFERENT APPROACH – LEGACY MANAGEMENT

Most successful families would not consider applying the traditional estate planning model in the context of their investment plan. For example, people generally do not create a retirement plan at age 30 and then wait until they turn 62 to see if that plan achieved their retirement goals; instead, they regularly evaluate the plan's progress and make needed adjustments. The same principle seems even more appropriate in managing a successful family's legacy, which generally involves many complex, moving pieces, including financial arbitrages, basis management, state and federal tax concerns, varied and sophisticated investments (e.g., hybrid life insurance-investment products, private equity holdings, operating businesses), and risk management.

What Families Get. If people, circumstances, and finances are in continuous motion, it should follow that families who regularly assess and adapt their plans increase the probability of successfully carrying on a multigenerational legacy. Accordingly, a legacy management approach provides families with a long-range (rather than episodic) planning continuum involving the outcome driven, active management of the family's global legacy plan. Key components of this approach include:

Collaboration. Collaboration with the family's team of advisors (insurance experts, investment advisors, accountants and attorneys) provides a greater understanding of the family's circumstances and the details of their existing planning and finances. This ensures all advisors work off the same data to minimize duplications, conflicts, and oversights in plan implementation and maintenance. It also allows the advisory team to anticipate and resolve complex tax and legal issues more efficiently based on team solutions.

Quantitative Analysis. The attorney's collaboration with the family's advisory team facilitates aggregation of the detailed financial data necessary to perform a quantitative analysis of the family's net worth and existing planning, including a comprehensive personal net worth statement, projected asset growth rate and annual living expenditures, estimated tax liabilities, available liquidity (considering all commitments, such as private equity capital calls), and remaining transfer tax exemptions. This analysis should be designed to: (1) identify the family's lifestyle and legacy capital (e.g., through a Monte Carlo simulation or similar financial modeling program); (2) quantify their potential tax liabilities and available liquidity; (3) clarify the flow and timing of assets to beneficiaries (i.e., what they would receive today for their lifestyle needs versus in the future as part of the post-mortem plan); and (4) illuminate any gaps in the family's existing planning and liquidity needs.

This upfront collaboration and quantitative analysis equip the family and advisors to make informed and accurate decisions regarding the legacy plan structure and distribution. For example, assume the parents want to provide lifetime financial security for their adult children now. By quantifying both the parent's legacy capital and the assets needed to sustain their children's lifestyle, the parents have an accurate benchmark for funding their children's legacy as well as the confidence to know that transferring such wealth now will not affect their own lifestyle going forward.

Post-Closing Maintenance and Tracking. Many legacy plan structures require compliance with numerous technical and administrative requirements post-execution. For example, with a "traditional" irrevocable life insurance trust, failing to properly fund the life insurance premiums, allocate GST tax exemption to the trust contributions, and/or send required "Crummey" withdrawal notices to beneficiaries can result in transfer tax issues. Development of, and compliance with, a post-execution maintenance plan helps ensure proper administration and implementation of any needed adjustments. The maintenance plan should assign responsibilities specifically to the appropriate advisor, including: (1) the on-going monitoring of economic, tax, and legal developments, specifically focused on the potential impact to the family and their legacy plan; (2) the tracking and planning for trust distributions, payments, and taxes; and (3) the coordination of required tax and other regulatory filings, notices, and accounts/reports.

Regular Reviews/Benchmarking. Legacy management requires regular iterative analyses and benchmarking of the legacy plan's overall performance, based on updated financial data and specified hurdle rates for each applicable component of the plan (e.g., applicable federal rate for intra-family loans or installment sales to grantor trusts, the Internal Revenue Code §7520 rate for grantor retained annuity trusts ("**GRATs**")). Just as with financial and investment planning, this benchmarking allows families and their advisors to evaluate the success of their legacy plan and make tactical adjustments in real-time as circumstances change and opportunities arise.

Combining this benchmarking with regular (annual) meetings between the family and their advisory team facilitates the plan's performance review on a consolidated basis, allowing advisors to present, and the family to consider, unified recommendations for planning enhancements and new opportunities based on current and anticipated developments. Following up with a post-meeting action plan helps to ensure implementation of the adjustments and recommendations by memorializing who is responsible for doing what and by when.

Cost vs. Value. The value added with a comprehensive legacy management approach generally exceeds its marginally higher price tag. Proactive management supported by a cooperative multi-disciplinary team helps families see what is on the horizon and efficiently navigate changes. Professional services rendered to implement and maintain a plan also eliminate many of the costly issues that routinely emerge when client use a less sophisticated or DIY approach.

Possibly even more important to intergenerational success, the annual family meetings offer a platform for educating descendants about managing the family legacy. By participating in these

meetings, children (and eventually grandchildren) can gradually learn about the family's goals, wealth, and philanthropic endeavors, and the social and fiscal responsibility needed to perpetuate them. Seeing these principles in action during family meetings builds the next generation's financial literacy and their understanding of their own roles in the family's mission, so that each generation is better prepared to not only preserve but also grow the family's legacy. Advisors also have the opportunity to counsel multiple generations of family members, strengthening the client relationship over the years.

LEGACY MANAGEMENT IN ACTION

GRATs are commonly used in legacy planning and can illustrate where the legacy management approach excels. With a GRAT, a grantor transfers assets to a grantor trust and retains the right to receive an annual annuity payment for a specified period. The present value of the annual annuity paid to the grantor is based on the §7520 rate. As a grantor trust, the grantor pays the income tax liability on the trust assets during the GRAT term (and on any continuing grantor trusts that are named as remainder beneficiaries of the GRAT). Any assets remaining at the end of the GRAT term pass to the grantor's designated beneficiaries, without gift or estate tax (assuming the grantor survives the term).

Accordingly, whether a GRAT successfully achieves the client's goals depends on the performance of the underlying assets relative to the benchmark 7520 rate at creation. At implementation, using a Monte Carlo analysis to identify which of a grantor's assets are more likely to outperform the benchmark from the outset can help plan for the GRAT's success. But what happens if there is significant investment volatility and/or the GRAT assets fail to perform as expected relative to the hurdle rate? Without monitoring or adjustments, the GRAT trustee could miss an opportunity to lock-in the GRAT's positive returns or to address investment underperformance early in the term in order to increase the chances that the GRAT will leave a positive remainder.

With a legacy management approach, however, the post-closing plan would assign the monitoring and regular benchmarking of the GRAT's performance to the investment advisor, who would share performance information with the GRAT trustee and attorney. Armed with this information, the advisors could recommend options for optimizing the GRAT's performance.

> ***Example***: James created a 3-year, zeroed-out GRAT funded with 30,000 shares in ABC Co. At funding, the share price was $66 ($1.98 million total), and the 7520 rate was 1%. The GRAT agreement provided James with a nonfiduciary power to substitute trust assets for assets of an equivalent value.
>
> In Year 1, the GRAT's shares increase in value to $83/share (almost 26%), for a total gain of $510,000. In Years 2-3, however, the share price fell and stayed at $68 per share. Compare the remainder value if James left the shares in the GRAT for the entire term, or if in Year 1, he substituted an equivalent value bond portfolio for the shares, which provided a 3% average annual return.

End of GRAT Term – Year 3	Substitution	No Substitution
GRAT Remainder (Out of Estate)	**$560,721**	**$143,260**

The decision to exercise the GRAT substitution power, however, must be made in real-time by an advisory team committed to actively managing the GRAT's success. Capitalizing on these types of opportunities would be simply impossible if no one monitored the GRAT's headway.

TAKE AWAYS

While traditional estate plans may cost less, the value added with a comprehensive legacy management approach generally exceeds its marginally higher expense. Proactive management supported by a cooperative multi-disciplinary team helps families see what is on the horizon and efficiently navigate changes. Professional services rendered to implement and maintain a plan also eliminate many costly issues that routinely emerge when clients use a less sophisticated or "DIY" approach. Regular interactions with the family to review performance also offer a platform for educating descendants about preserving and growing the family's legacy, while providing advisors with the opportunity to counsel multiple generations of family members, strengthening client relationships over the years.