Morgan Stanley

PRIVATE WEALTH MANAGEMENT

Topics in Wealth Strategies:

A "Successful" Trust Tax & Estate (TTE) Plan = TTE Strategy + "Executed" TTE Implementation

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Trust, Tax & Estate (TTE) Planning Is An Ongoing Management Process

Ongoing Management: TTE planning is not a static one-off exercise; rather, it requires ongoing management to maintain relevance against the backdrop of both changing and evolving life events, personal preferences and economic factors. The TTE strategy determines the capital allocation of assets across family, charity and the government. The TTE implementation drives the success of the TTE strategy by delineating between what must be executed and what might be executed according to wealth levels, thereby creating a rules-based approach to TTE planning that may be more easily communicated to investment professionals and lawyers who may assist in navigating the economic environment.

A Trust Tax & Estate (TTE) strategy has the potential to be effective if executed properly. For a successful TTE plan, it is critical to create a TTE implementation in combination with a TTE strategy.

TTE Plan = TTE Strategy + TTE Implementation.

A TTE strategy often tends to be when people get around to it perhaps after putting it off for periods of time or when triggered by a life event. Thus, the timing of TTE implementation may be more arbitrary than intentional, and actions more reactive and rushed than prescribed. While this may work, a TTE plan may be improved.

Identifying Opportunities: TTE implementation deploys the desired techniques as and when it makes sense and market opportunities arise. TTE implementation and sequencing its component parts are critical for successful execution. The key is to understand the role of life events and personal preferences as well as economic factors in determining what TTE techniques to execute and under what parameters and circumstances.

How TTE Addresses Changing and Evolving Environments

Life Events and Personal Preferences:

Considering life events and personal preferences; delineating between what should be in place and what could be in place; and creating predetermined rules-based execution decisions according to wealth levels may alleviate overwhelming complexity and behaviors that postpone TTE execution.

Must-Haves Versus Nice-to-Haves:

Identify:It is important to have clearly defined goals and a good understanding of the principles of TTE planning.

Distinguish and Classify: By focusing on what to accomplish and how techniques are generally applied, it becomes clear which techniques are necessary (appendix A) and which ones might be considered in the future (appendix B) should certain criteria and wealth levels be attained.

Wealth Levels:

Generally, there are techniques to address federal income taxes, estate taxes and both together, but to do so usually means transferring assets to other beneficiaries whether they are charities family members or others (appendix C).

During Life: It is essential that individuals understand how much is needed for their lifetime (the floor) plus a contingency for unexpected developments (the cushion) before utilizing any remaining assets (the surplus) for the techniques.

After Death: Ultimately, the choice and combination of techniques utilized will determine the level of assets that go to beneficiaries, charity and taxes.

Memorialize the Implementation:

Understanding: It may be helpful to have a visual representation of the flow of assets after each spouse passes away to reconfirm understanding, intention and salient details (appendix D).

Action Plan: Ultimately, one is determining what must be done immediately and creating a list of potential options to consider when specific milestones are met over time.

Accountability: The written implementation establishes a benchmark against which to measure progress and guidelines for annually reevaluating relevant options.

Economic Factors:

Economic factors may have a significant impact on and play a salient role in the implementation of a TTE strategy. Fiscal and monetary policy establishes the backdrop for TTE opportunities and challenges. While financial markets drive the investments made in TTE structures, it is important to also understand that many of the TTE techniques are structured like bonds, and the rates that prescribe them are also affected by the market and therefore are timing-dependent.

- **Fiscal policy—**determines tax rates (income and estate) and permissible exclusions and deductions (appendix E).
- **Monetary policy—**underpins market rates and the yield curve that determine the hurdle rates of TTE technique (appendix F).
- **Financial market—**creates investment opportunities across asset classes to invest the assets of TTE structures (appendices G,H).

Sequencing Deployment of TTE Techniques

Life Cycle	Source of Cash Flow	Asset Stage	Total Net Worth	TTE Strategy	TTE Implementation	Investment Considerations
Education	**None**	**Dependent**	**Floor -** less than lifetime exemption(s)	**Must-haves**	**Fiscal Policy** - tax rates and available exemptions	**Asset Allocation**
Work - private firm	**Compensation**	**Accumulation**				
Work - public firm						
Family - home						**Asset Location** across taxable, deferred and exempt techniques
Family - marriage						
Family - children						
Retirement	**Investments**	**Distribution**	**Buffer**	**Nice-to-haves**		
Legacy - philanthropy			**Surplus**		**Monetary Policy** - level of interest rates and shape of yield curve	
Legacy - family						

Appendix A – Must-Haves: Estate Planning Necessities

CONTROL OF ONE'S ASSETS AFTER DEATH

Will

- A will is an instrument that disposes of a person's property at death in accordance with the decedent's wishes. A will takes effect only after the time of the decedent's passing and, until that time, may be revoked or amended
  - Property passing by will (all individually titled property) is called "probate property," as probate is the judicial procedure by which a will is proven to be validly executed. The original will is filed with the probate court, and it is a public document.

Revocable Living Trust

- A trust is effectively a contract by which an individual (the grantor) transfers property to a trustee who is under a fiduciary duty to manage, invest and administer the property for the benefit of designated beneficiaries as directed by the trust instrument
  - A revocable trust is a trust created during the grantor's lifetime and can be amended or revoked; the grantor is considered to still own the assets in the trust for federal income and estate/gift tax purposes.
  - The trust becomes irrevocable on death of the grantor and can act as a will substitute or in conjunction with a will. Moreover, the assets in the trust avoid probate (and publication, because, in contrast to a will, a trust is a private document).

CONTROL OF ONE'S ASSETS DURING LIFE

Revocable Living Trust

- If the grantor of a revocable living trust becomes incapacitated, the terms of the trust govern the disposition of the trust's property (rather than an agent under a power of attorney or court-appointed person).

Power of Attorney

- A power of attorney is an instrument by which a person (the principal) appoints another person (the agent) to act on the principal's behalf with respect to any or all of the principal's property, as specified in the power of attorney
  - A power of attorney can be made "durable" so that it survives the principal's incapacity or disability. In some states, it can also be effective immediately upon execution or "spring" into effect at a specified future time or upon the occurrence of a specified event such as the principal's incapacity or disability.

CONTROL OF ONE'S PERSON DURING LIFE

Health Care Proxy

- A health care proxy is an instrument by which an individual (the principal) grants another person (the agent) the authority to make health care decisions in the event the principal becomes unable to make such decisions (including decisions with respect to the withholding or withdrawal of life-sustaining medical treatment and artificial nutrition and hydration).

Living Will

- A living will is an instrument by which individuals express their intent or preferences with respect to health care matters, including the withholding or withdrawal of life-sustaining medical treatment and artificial nutrition and hydration.
- Generally, if an individual has executed a health care proxy, the health care agent must act in accordance with the principal's wishes. A living will generally serves as specific evidence of those wishes.

Appendix B – Nice-to-Haves: Basic and Advanced Estate Planning

ESTATE PLANNING: BASIC GIFTING

Annual Exclusion

- Each person can make gifts of the annual exclusion amount to any number of individuals without incurring federal gift tax or using federal gift tax exemption (married couples can gift twice the amount per year, per donee).

Medical/Education

- Direct payments of certain medical and educational expenses (without limit) are excluded from the federal gift tax. Neither counts against the annual exclusion

Applicable Credit/Exempt Amounts

- Each individual receives an inflation adjusted-exemption from the federal gift, estate and GST taxes. Federal gift, estate and/or GST tax may apply to any excess. Certain states also impose a gift tax in addition to the federal gift tax and/or impose an estate or inheritance tax in addition to the federal estate tax.

ESTATE PLANNING: LEVERAGED GIFTS/ESTATE FREEZE STRATEGIES

Grantor Retained Annuity Trust (GRAT)

- Assets placed in trust with donor retaining an annuity and making a gift of the remainder to family members.
- Annuity amount is valued using an IRS benchmark rate
- Upon termination of trust, the remainder of the property after payment of the annuity to the grantor will pass to the remaindermen of the trust, with all appreciation over the benchmark rate in effect, passing free of an additional federal gift tax.

Sale to Defective Grantor Trust

- Assets can be sold to a trust for the benefit of one's family. The trust can purchase the property by giving the donor a note bearing a market interest rate. Because the trust income is taxable to the grantor, the sale and payment of interest do not result in tax recognition.
- When the trust terminates, the property will pass to the remaindermen of the trust, with all appreciation over the interest rate on the note, in effect, passing free of an additional federal gift tax.

Qualified Personal Residence Trust

- Primary residence and/or a vacation home can be transferred to a trust with the donor retaining use of the property for a term of years. Remainder gifted to family.

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Charitable Remainder Trust (CRT)

- Assets placed in trust with donor (or other individuals) retaining an income interest and making gift of remainder to charity.
- Income interest taxable to non-charitable recipient, but CRT itself tax-exempt, allowing assets remaining in trust to grow tax-deferred.

Charitable Lead Trust (CLT)

- Asset placed in trust with donor granting an income interest to a charity free of federal gift tax and making a taxable gift of the remainder to family.
- Upon termination of trust, the property will pass to the remaindermen of the trust (generally, family members) with all appreciation over the benchmark rate, in effect, passing free of an additional federal gift tax.

Public Charity

- Entity supported and controlled by public or government, which advances charitable purpose.
- Higher income tax deductibility limitations.
- Not subject to private foundation rules

Private Non-Operating Foundations

- Privately funded entity that advances charitable purpose through grant-making.
- Can be controlled by donor/family.
- Lower income tax deductibility limitations.
- Subject to private foundation rules.

Operating Foundation

- Private foundation that actively advances its charitable purpose.
- Can be controlled by donor/family.
- Higher income tax deductibility limitations.
- Subject to private foundation rules.

Supporting Organization

- Quasi-private foundation linked to a public charity.
- Control shared between public charity and donor/family.
- Higher income tax deductibility limitations.
- Subject to some private foundation rules.

Appendix C – Wealth Levels: Techniques by Wealth Level

	INCOME TAX PLANNING	INCOME TAX AND ESTATE PLANNING		ESTATE PLANNING
	INCOME TAX PLANNING	SPLIT INTEREST GIFTS	PHILANTHROPY	WEALTH TRANSFER
All Wealth Levels	• Long-Term Capital Gains • Qualified Dividends • Options • Charitable Tax Deduction • Tax-advantaged Investment Vehicles		• Donor Advised Fund (DAF) • Public Charity	• Wills/Revocable Trusts • Health Care Documents • Financial Powers of Attorney • Annual Exclusion Gifts • Qualified Medical and Tuition Exclusions Gifts
One Lifetime Exclusion		• Charitable Remainder Trusts (CRT) • Charitable Lead Trusts (CLT)		• Testamentary Credit Shelter Trusts (CSTs) • Irrevocable Life Insurance Trusts (ILITs) • Leveraged Gifting – Grantor Retained Annuity Trusts (GRATs) – Sale to Irrevocable Grantor Trusts (IDGTs) – Qualified Personal Residence Trusts (QPRTs)
Two Lifetime Exclusions			• Private Foundation	• Use of Federal Gift Tax Exemption • Irrevocable Trusts • Dynasty Trusts

Appendix D – Memorialize the Implementation: Example of Select Will and Trust Provisions

Last Will and Testament

- Tangible personal property to surviving spouse; residue "pours over" to the revocable trust.

Revocable Trust

- Trustees: Trust instrument appoints the initial trustees of the trust. Upon the death or incapacity of one spouse, the survivor becomes sole trustee. Upon the death of both, trust instrument designates successor trustees or a procedure for designating successor trustees.
- During the lives of grantor and spouse, net income and principal are paid as they wish. If grantor is incapacitated, distributions may be made to grantor, spouse and family.

Irrevocable Trust

First death

Funded with unused federal estate tax exemption

Intended to receive balance, if any

Family Trust

- Income is paid to surviving spouse;
- Principal is distributed to the surviving spouse at the discretion of the trustee for the survivor's health, education, maintenance and support;
- The trustee may distribute principal for the health, education, maintenance and support of the issue of the deceased grantor.

Marital Trust

- Surviving spouse receives all net income quarterly, and discretionary principal for health, maintenance and support

Terms

Second death

Trusts for Children

- The balance of the remainder in equal shares for each child who survives both grantors or has left surviving issue.
- Principal distribution to Child five years after death of the last grantor to pass away.
- If a child has died leaving children of their own, these children split the child's share, and that share is paid to these grandchildren of Grantor at ages 40 (1/3), 45 (1/2) and 50 (remaining balance).

Appendix E - Economic Factors: Fiscal Policy

Fiscal policy and the ability and need of the federal government to tax and spend underpin the prevailing federal income, gift, estate and GST tax rates as well as transfer tax exemptions and annual exclusions and charitable deductions. Depending on the health of the economy and the government, as well as the balance of power between political parties, the laws that dictate these specifications change over time thus creating and reducing potential opportunity for TTE planning.

How Much TTE Planning Might Be Considered:

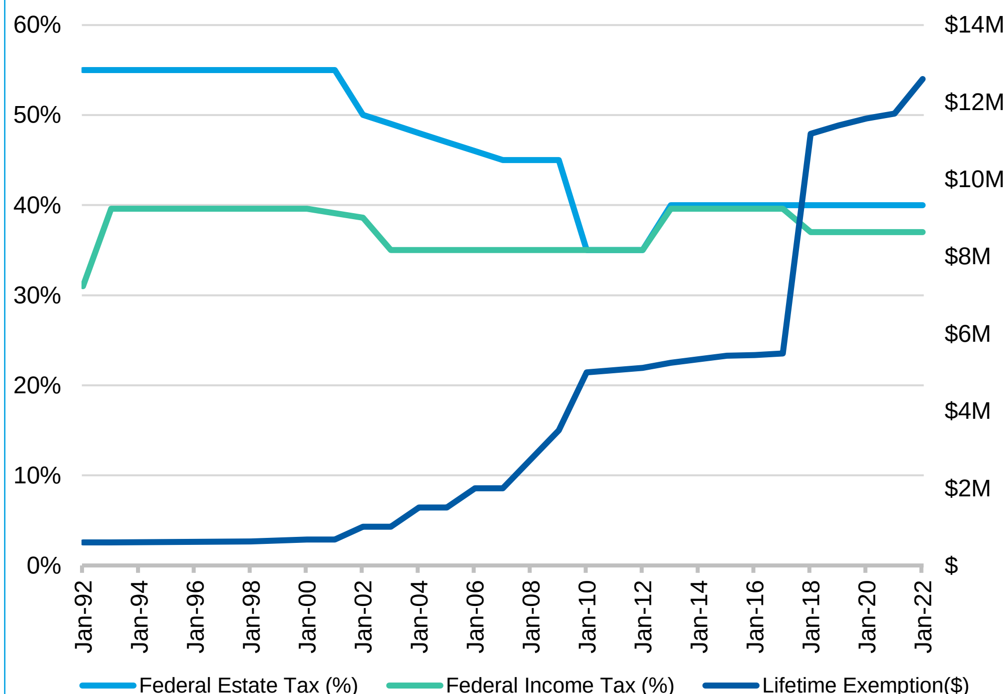
- Higher income and estate taxes and lower exemptions and deductions inspire more TTE planning.
- Lower income and estate taxes and higher exemptions and deductions may lead to less TTE planning.

Overview of Current Laws

	2022	2023
GIFT (LIFETIME) AND ESTATE TAX EXEMPTION	• $12.06MM	• $12.92MM
GENERATION-SKIPPING TRANSFER TAX EXEMPTION	• $12.06MM	• $12.92MM
TOP GIFT, ESTATE, GST AND INCOME TAX RATES	• Transfer Tax 40% • Federal Income Tax 37% • Additional Medicare Tax 0.9%	• Transfer Tax 40% • Federal Income Tax 37% • Additional Medicare Tax 0.9%
TOP LONG-TERM CAPITAL GAINS AND QUALIFIED DIVIDENDS RATE	• 20% • Net Investment Income Tax 3.8%	• 20% • Net Investment Income Tax 3.8%
QUALIFIED CHARITABLE CONTRIBUTION (FROM IRA FOR THOSE OVER 70.5)	• Yes	• Yes
GRATS/FLP DISCOUNTING	• Unchanged	• Unchanged

Sources: Estate Tax and Exemptions - Taxfoundation.org/federal-estate-and-gift-tax-rates-exemptions-and-exclusions-1916-2014, Resources.evans-legal.com/?p=3627
Tax Brackets -moneychimp.com/features/tax_brackets.htm, Taxfoundation.org/historical-income-tax-rates-brackets/

Taxes and Exemptions



Sources: Estate Tax and Exemptions - Taxfoundation.org/federal-estate-and-gift-tax-rates-exemptions-and-exclusions-1916-2014, Resources.evans-legal.com/?p=3627
Tax Brackets -moneychimp.com/features/tax_brackets.htm, Taxfoundation.org/historical-income-tax-rates-brackets/

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Appendix F – Economic Factors: Monetary Policy

Monetary policy conducted by the Federal Reserve intends to promote employment and stable prices by managing the level of short-term interest rates and the overall availability and cost to borrow. Monetary policy directly and indirectly affects interest rates across maturities of the U.S. Treasury yield curve. It is the yield curve that provides the basis for the rates specified by the Internal Revenue Service (IRS).

Hurdle rates for private and intra-family loans (AFR):

Specifically, the IRS publishes the Applicable Federal Rates (AFRs) used as the basis for setting minimum interest rates for private or intra-family loans, such as sales to intentionally defective grantor trusts (IDGTs). Depending on the term of the loan, there are three AFRs: short term, midterm, and long term. Short-term AFR rates are determined from the one-month average of the market yields from marketable obligations, such as U.S. government T-bills with maturities of three years or less. Midterm AFR rates are from obligations of maturities of more than three and up to nine years. Long-term AFR rates are from bonds with maturities of more than nine years.

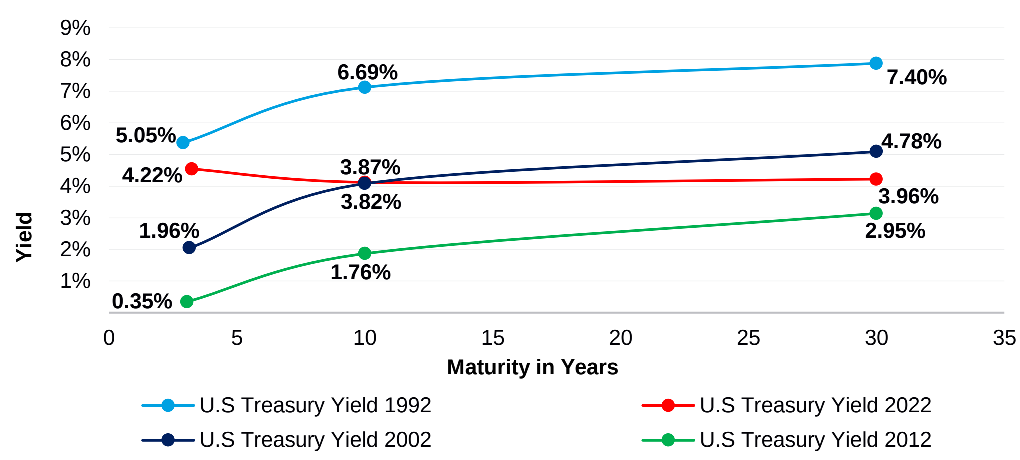
Hurdle rates for split-interest trusts (7520):

The IRS also publishes the 7520 rate used to determine the value of the respective interests of split-interest trusts, examples of which include charitable remainder trusts (CRTs), charitable lead trusts (CLTs), grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs). The 7520 rate is 120% of the applicable federal midterm rate. (Source: Evans Estate Law Resources, 2020).

Which TTE Techniques Might Be Considered:

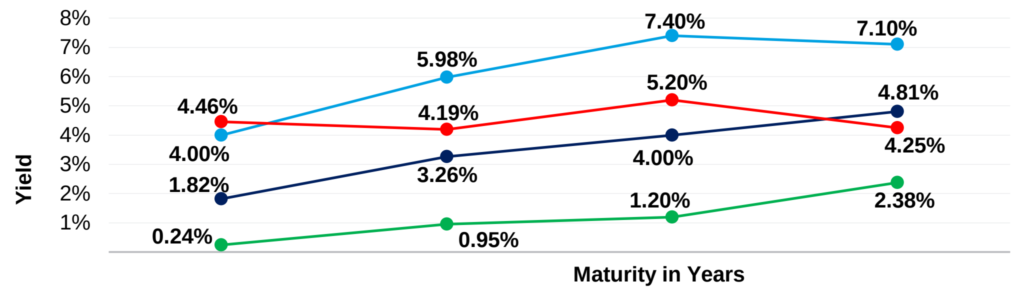
- Low interest rate environments make GRATs, IDGTs and CLTs more favorable.
- High interest rate environments make QPRTs and CRTs more favorable.

US Treasury Yield Curves



Source: Bloomberg

AFR and 7520 Rates

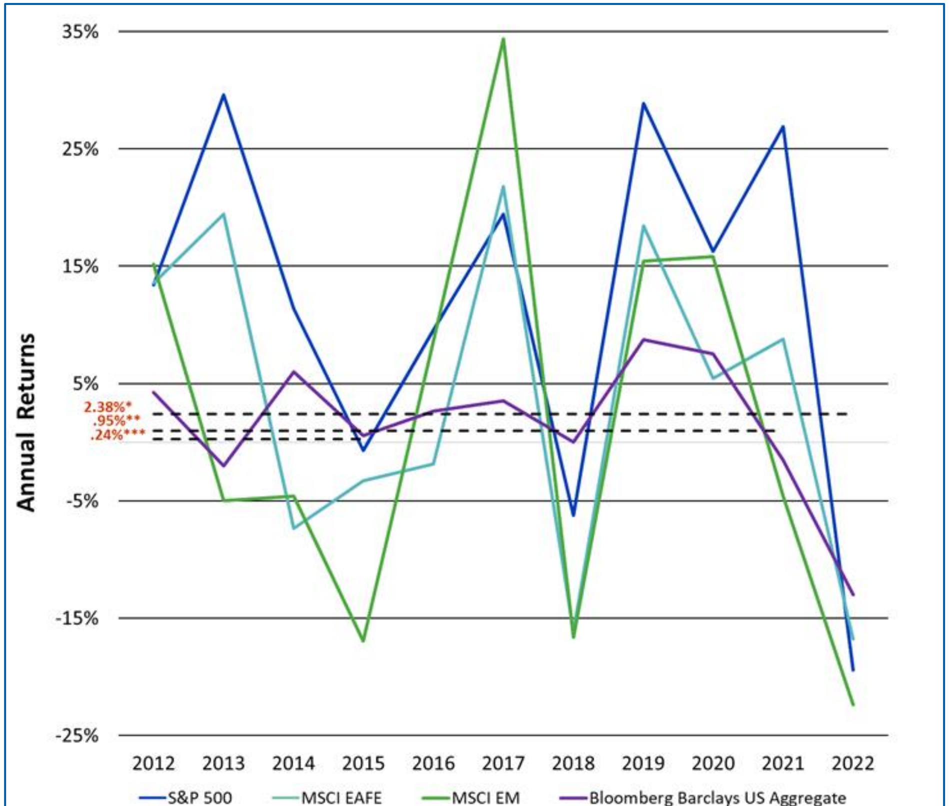


	0 – 3 Treasury Yield - AFR Short-Term Rate	3 – 9 Treasury Yield- AFR Mid-Term Rate	7520 Rate – 1.2 AFR mid-term	> 9 Treasury Yield - AFR Long-Term Rate
December 1992	4.00%	5.98%	7.40%	7.10%
December 2002	1.82%	3.26%	4.00%	4.81%
December 2012	0.24%	0.95%	1.20%	2.38%
December 2022	4.46%	4.19%	5.20%	4.25%

Source: resources.evans-legal.com/?p=2591, reninc.com/irs-rates-history

Appendix G – Economic Factors: Financial Market + Asset Allocation

Financial markets drive asset class performance and risk, and as such, contribute to the efficacy of TTE planning. Each TTE technique has its own objectives and risk characteristics, which, when taken together, should contribute to and complement the overarching risk profile of the beneficiary. The determination of a risk profile and its maintenance, inclusive of the TTE planning, are critical. The opportunity lies in marrying the characteristics of both the asset classes and the TTE techniques that house the assets. To do this, care should be taken to purposefully employ asset location in addition to asset allocation and subsequent investment decisions.



***Short-term AFR as of December 2012 **Mid-term AFR Rate as of December 2012 *Long-term AFR Rate as of December 2012

Source: Bloomberg

What Asset Classes Should Be Considered in which TTE Techniques

- Tax-inefficient asset classes within tax-exempt and deferred techniques
- Tax-exempt asset classes within taxable techniques
- Higher return and risk assets in aggressive and nice-to-have techniques
- Lower return and risk assets in conservative and must-have techniques

Timing: Putting It All Together

Finally, understanding and appreciating the impact of market timing on the interdependence of a TTE strategy (selection of TTE techniques) and TTE implementation (deployment of a TTE technique and selection and combination of asset classes) are key to successful TTE planning. Specifically, when a TTE structure is initiated over a specified time period, the IRS dictates the “hurdle” rate (AFR and/or 7520 rate), which becomes the benchmark for the investments over that time horizon. To put this into context, using historical data that is not an indication of future performance, take for example a TTE technique that was created using the long-term AFR rate as of December 2012 of 2.38%. From the following chart, one may see the annual returns of various asset classes over the subsequent decade to understand which asset classes generated returns exceeding the AFR rate of 2.38% and those that generated returns of less than 2.38% to understand the relative contribution to the success of the TTE technique.

Appendix H – Economic Factors: Financial Market + Asset Location

ASSET CLASSES	TAXABLE			
	GRAT	**Grantor CLAT**	**Non-Grantor CLAT**	**IDGT**
GENERAL	• Can be funded with illiquid assets, but they must be appraised annually • In-kind distribution • Diversification is not important • Volatility is important	• Want upfront federal income tax deduction to be greater than federal income taxes paid during lifetime of trust • Tax-efficient assets with growth potential are appropriate	• Trust pays its own taxes, but the annuity gives the trust a federal income tax deduction, so can invest in less tax efficient assets • Appropriate for low-basis assets	• Potentially lower interest rate than GRAT • Balloon repayment structure: greater deferral of trust payments allowing assets to compound for the benefit of beneficiaries (more leverage benefit) • Potentially more auditing risk than GRAT • Not appropriate: illiquid + no income • No in-kind payments • Appropriate example: properties with stable rental income
EQUITY **U.S. INT'L, EMERGING**	• Put assets with upside potential consistent with time period of GRAT	• High dividend stocks to generate income to assist with annuity payment		• High dividend stocks to generate income to assist with loan servicing
FIXED INCOME **U.S. INT'L, TIPS, HIGH YIELD, EMERGING, TAX-EXEMPT**	• Fixed income investments may not be appropriate in these structures Private Foundation			• Taxable entities may benefit from investing in tax-efficient asset classes like municipal bonds; TIPS may generate phantom income and create cash flow challenge
ALTERNATIVES **MASTER LIMITED PARTNERSHIPS, REAL ESTATE INVESTMENT TRUSTS, COMMODITIES**	• GRAT remainder transferred with original cost basis			
HEDGE FUNDS	• Not advised given illiquidity		• Offshore to block unrelated taxable income (UBTI)	
PRIVATE DEBT, PRIVATE EQUITY, PRIVATE REAL ESTATE	• Not advised given difficulty marking to market	• Beware of generating UBTI		
CASH	• Only to freeze a successful GRAT • May be used to fund a GRAT alongside illiquid shares prior to a liquidity event			• Appropriate for IDGTs
RISK CONSIDERATIONS	• Aggressive	• Moderate	• Moderate	• Moderate

Appendix H – Economic Factors: Financial Market + Asset Location (cont'd)

ASSET CLASSES	TAX-EXEMPT		TAX-DEFERRED	
	Public Charity/DAF	ILIT	CST	CRT
GENERAL	• Investment options can be limited to mutual funds for DAF; since tax-exempt, can invest in more tax-inefficient asset classes			• Funded with a low-basis position and allows you to diversify; taxes paid on distributions in order of worst first
EQUITY **U.S. INT'L, EMERGING**			• More aggressive because it can be held for more than a single generation	
FIXED INCOME **U.S. INT'L, TIPS, HIGH YIELD, EMERGING, TAX-EXEMPT**				
ALTERNATIVES **MASTER LIMITED PARTNERSHIPS, REAL ESTATE** **INVESTMENT TRUSTS,** **COMMODITIES**	• Cost basis management for separately managed accounts with numerous K-1 investments is time consuming and costly			• Commingled vehicle to block UBTI
HEDGE FUNDS	• Offshore to block UBTI	• Nondirectional hedge funds often used to invest cash value in private placement life insurance		• Offshore to block UBTI
PRIVATE DEBT, PRIVATE EQUITY, PRIVATE REAL ESTATE	• Beware of generating UBTI	• Not advised given difficulty marking to market		• Beware of generating UBTI
CASH				
RISK CONSIDERATIONS	• Moderate	• Conservative	• Aggressive	• Moderate

Disclosures

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Caution: many estate techniques share the common risk of the loss of control of the assets once the gift of the assets is complete.

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