The Dynamics of Wealth Transfers

An enormous transfer of wealth is occurring as baby boomers leave their assets in the care of younger generations.

According to BenefitsPRO[1], this total transfer could amount to $70 trillion, and millennials can expect to be the primary beneficiaries (although Generation X has begun inheriting wealth also). Although millennials currently hold less than 5% of U.S. wealth per CNBC[2], many will soon be expected to make significant financial decisions as more money flows their way. But transferring wealth and related assets can be complicated, and there are several techniques that a business owner or other individual can adopt when determining what's best for them and their beneficiaries. So, before taking any action, the benefactor must answer key questions:

- Do I still need income?
- Do I want to gift the asset but retain control?
- Do I want to minimize estate taxes?
- How old am I, and how healthy?

Once these questions are answered, there are different wealth transfer strategies to consider. Below are some of the main options.

Installment Sale

The benefactor sells their business or asset over several years in separate installments. This method allows the seller to postpone paying taxes on the asset throughout this period, and gives the buyer more time to secure funding, potentially driving up the sale price. The benefactor also establishes cash flow while removing an appreciating asset – and future installment payments – from their estate. The primary disadvantage to this strategy is that if the seller dies before the installment payments are complete, the unpaid value of the asset remains in the estate.

[1]https://www.benefitspro.com/2020/11/19/the-great-wealth-transfer-what-boomers-and-their-families-need-to-know/
[2]https://www.cnbc.com/2020/10/09/millennials-own-less-than-5percent-of-all-us-wealth.html

Self-Canceling Installment Note (SCIN)

A variation of the installment sale, wherein any remaining payments are cancelled after the seller's death and excluded from the estate. The buyer pays a premium for the asset in exchange for the self-canceling possibility. Any remaining payments appear on the seller's final income tax; this method is appropriate for ultra-high-net-worth individuals who have a 40% estate tax.

Sale Lease Back

The benefactor sells a business asset and the buyer leases it back to the company. This strategy allows the business owner to continue using the asset while deducting the lease payments as a business expense. Additionally, the asset is removed from the seller's estate.

Gift Lease Back

The benefactor gifts a fully depreciated business asset to a child or family member in a lower tax bracket. The asset is then leased back to the company. This method allows the business owner to continue using the asset and deduct the lease payments as a business expense. The asset and the income stream of the lease is removed from the business owner's estate.

Bargain Sale

The sale of property that is a combination of a sale and a gift. The sale is arranged for the buyer to purchase the property at a discounted price. The difference in the sale price and the fair market value is structured as a gift.

S Corporation (Gifting Shares)

The annual gift tax exclusion shares of an S Corp are transferred to younger family members. The income associated with the shares is shifted to the receiving family member and the shares are removed from the original owner's estate. It is important to have a certified valuation done to determine the percentage gifted each year, based on a valuation formula. It is also critical to be aware of the kiddie tax rules if the recipient is under the age of 24.

Family Limited Partnerships (FLPs)

FLPs are a structure used to transfer interests of illiquid family investments or business. Due to the nature of their illiquidity the IRS allows the asset to be substantially discounted during the transfer. The transferee of the FLP interest can claim a "lack of control" discount, as the general partner controls the management of the business. The limited partners are unable to sell their interests, thus the transferee also receives a "lack of marketability" discount. As a result, these discounts allow for a larger percentage of the partnership's interest to be passed using the annual gift exclusion. A third-party appraisal is wise, if not essential when claiming a discount. There are disadvantages to this strategy, however. One, the transfer of interest is passed with the original basis and does not receive a step-up at the time of death. Two, the general partner has unlimited business liability for claims on the business.

In addition to these options, there are other strategies by which you can maximize charitable and generational gifting to bolster your financial situation and receive tax deductions. These options are provided below.

Bunching

The bunching technique is meant to act as a pre-payment of your charitable donations. Under current tax law, the standard deduction is $24,000 for married couples filing jointly. Through bunching, you gain the benefit of multiple years of donations in a shorter amount of time, surpassing the $24,000 deduction. In short, the benefactor makes two years' worth of charitable donations in one year, but this top-heavy approach can be eased with the use of a Donor Advised Fund (DAF). When funds are contributed to a DAF, the deductibility of the contribution is triggered, and an advisor can then help the benefactor distribute all, some or none of the funds to any desired charities at any rate.

A Qualified Charitable Distribution (QCD) can also facilitate the bunching process. All taxpayers who are aged 70 1/2 or above, and who are required to take a minimum distribution from their retirement accounts may direct up to $100,000 annually for a QCD. This income, which is normally taxed as ordinary income, is not reported on the tax return when directed to a charity. There is no charitable deduction on top of this – the government doesn't want double-dipping – and these are not allowed to be directed to a DAF.

Gifting Non-Cash Assets

In America, an average of 70%[3] of charitable contributions come from individuals, and most of them gift with cash. However, appreciating assets, such as stock, real estate and business interests can be extremely beneficial from a charitable standpoint. For example, if you give shares of a corporation with a long-term gain of $100,000, you get a tax deduction for the fair market value of the shares on that day ($100,000). In addition, you will not have to pay the income tax which would be due on the gain, allowing you to give the full amount to charity. An additional benefit of gifting appreciating property is that you get the asset, as well as the appreciation out of your estate. Gifting appreciating assets can also be helpful in passing wealth to the next generation, as heirs will inherit the benefactor's basis in the property. If they sell, they will incur the income tax associated with the gain, but this strategy will nonetheless minimize estate taxes.

In the case of a 529 plan for a child or grandchild, the IRS allows benefactors to make up to 5 years' worth of gifts. Within this account, the assets will grow tax free if the money is used for educational purposes, but these plans can only be funded with cash. Another strategy to help gift to heirs is to gift them an annual contribution to fund a Roth IRA. Once the beneficiary gains access to the money at age 59 1/2, the funds will have grown significantly as tax free assets.

Family Dynamics

In addition to all the financial strategies you can take when navigating a wealth transfer, it's important to note that transferring wealth can be a very personal process that forces the family to assess its relationships and draw financial plans accordingly.

One of the most important ways to navigate these challenges is by encouraging open lines of communication with all beneficiaries. If somebody is expected to manage a trust, for example, that person would need to be

[3]https://givingusa.org/giving-usa-2020-charitable-giving-showed-solid-growth-climbing-to-449-64-billion-in-2019-one-of-the-highest-years-for-giving-on-record/

fully aware of their responsibilities. In other cases, to avoid making poor decisions with an upcoming inheritance, beneficiaries need to adopt a financial plan. This plan should feature short and long-term goals, anticipate future sources of income and include a budget for any lifestyle changes the new wealth might inspire. Beneficiaries should also account for how taxes may impact their inheritance, as estate tax laws can be a significant impediment to optimizing new wealth. Financial advisors can provide critical guidance when a beneficiary wants to reduce taxes or otherwise manage incoming assets.

Transferring wealth to beneficiaries or the next generation can seem complicated, but with the aid of a financial advisor — and with all options on the table — a better-informed decision can be made.

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