

STRATEGIES FOR TRANSFERRING ASSETS



Almost everyone as they approach retirement must consider the financial arrangements necessary to support them when they no longer have earned income. At the same time, parents may wish to find ways to transfer assets to their children to keep them out of their estate. To achieve both requires planning, and a significant part of the planning process relates to tax strategies and estate planning.

GIFTING

Gift-giving is one of the more common ways to transfer equity from one generation to another. Gifts of present interests up to \$11,000 per donee in each calendar year are not taxable. Accordingly, a husband and wife can give up to \$22,000 per donee annually. This annual exclusion is now inflation adjusted, but remains at \$11,000 for 2004. Amounts in excess of these exclusions are taxable as part of the unified federal estate and gift tax structure.

The Federal estate and gift tax rates begin at 45% for transfers in excess of the \$1,500,000 unified credit equivalent, increasing to over 48% for estates exceeding \$2,000,000. For gift tax purposes the annual exclusion remains at \$1,000,000.

Spouses may, however, transfer an unlimited amount of assets without any gift or estate tax liability.

When an individual transfers assets to a grandchild an additional tax is imposed, called the GSTT or "Generation Skipping Transfer Tax." The GSTT is applied at the 48% rate. However, there is an exemption which permits an individual to up to \$1,500,000 free of the GSTT. Since the GSTT is added to the gift and estate taxes, gifts to grandchildren can be costly from a tax basis.

VALUATIONS OF BUSINESSES

Since the IRS imposes stiff penalties for undervaluing assets, any plan to transfer business assets should include a business valuation. The IRS virtually requires that valuations be made prior to any sort of potentially taxable distribution of equity. Valuation of stock in a privately owned company may be reduced by a varying amount, which can be as much as 35% or more for "lack of marketability," as well as various adjustments for the lack of control possessed by minority interests. Valuation of a privately owned company may be reduced by a varying amount, which can be as much as 35% or more for "lack of marketability" as well as various adjustments for the lack of control possessed by minority interests.

To maximize the available discounts corporations can have "voting" and "non-voting" stock. If the company is recapitalized with both kinds of stock, the non-voting stock can be used to transfer a much larger percentage of the company with the greater discounts applicable to a minority interest.

VARIOUS STRATEGIES

Perhaps the most common strategy is an **Outright Gift**. The donor may make tax exempt gifts of up to \$11,000 per year and use the \$1,000,000 exclusion. A married couple may make gifts of \$22,000 per year

up to \$2,000,000, even if the assets gifted belong only to one spouse. When an asset is gifted its basis will remain the same as the basis of the donor, so the recipient would have to pay capital gains taxes on the sale at the old basis. If the assets were transferred through an estate the recipient receives a new basis. However, if the recipient does not plan to sell the assets in the foreseeable future, gifting is usually still preferable to inheritance, as it removes the future appreciation and income from the donor's estate.

The donor may make a **Gift to a Grantor Trust**. If the gift is made to a Grantor Trust, the donor may pay income tax on the trust's income, even though the income is retained in the trust. The payment of the taxes is not considered a gift, so this strategy enables a donor to increase the amount that he can give that is not subject to gift tax.

Another vehicle that can be used is a **Grantor Retained Annuity Trust**. Assets are transferred to a trust in which the Grantor retains an annuity interest for a period of years, at the end of which the principal balance is distributed to the beneficiaries of the trust. The distribution is considered taxable as a gift, but the retained annuity causes its value to be reduced. For gift tax purposes the value is the total value of the property less the present value of the retained annuity. The present value of the annuity is determined by the annuity amount, the number of years it will be received, and a current interest rate.

Another strategy is an **Installment Sale**. This strategy is particularly effective for an interest in a business or other assets that are growing in value. The value of the assets can be "frozen" in an installment sale, as it is calculated at the time of the sale. The owner reports capital gain and interest income, but any appreciation after the sale is not included in the owner's estate. A variation of this strategy is a **Self Canceling Installment Note**, which means that the installment obligation expires with the

seller's death. To qualify, the buyer must pay a premium either in the sales price or interest rates.

Creation of a **Private Annuity** provides for a transfer of assets and assures the parent of lifetime income. The owner's children make an agreement to provide periodic payments for the transferor's life in exchange for the assets or equity in the company. This approach removes the company or assets from the owner's estate, while still producing future income. At the owner's death there is no asset in his estate to tax.

Another widely used strategy is the **Family Limited Partnership**. A partnership may be created with general partners and limited partners. The assets are transferred to the partnership. The general partners (the parents generation) may have a partnership interest of as little as 1% but retain control over the management of assets and all distributions. However, a 99% interest in these assets can be transferred to their children in the form of limited partnership units.

If the asset being transferred is a business there are two common denominators to all of these strategies. All require an accurate valuation of the business. In addition every shareholder of a privately held business should have a buy-sell agreement in place to govern the disposition of their stock in the event of death, disability, retirement, or withdrawal from the business. The buy-sell agreement can be in the form of stock redemption or cross-purchase, and may be funded by disability or life insurance.