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Managing Philosophical and Practical Considerations of Wealth Transfer

Charles Dickens explored the depths of internal conflict throughout his writings but perhaps never more vividly than through his iconic character, Ebenezer Scrooge. In fact, the etymology of the character's name hints at the same personal strife that Dickens sought to explore in "A Christmas Carol:"

Ebenezer is from the Hebrew *ebhem ezar*, meaning "stone of help," a nod to the story of Samuel and what he believed to be divine assistance in a moment of need[1]; and

Scrooge, now commonly meaning "miser," was at the time an invented word by Dickens but believed to be a derivation of "scrouge" which was a root of "scrounge," or to "rummage" or "pilfer."[2]

Dickens's combination of the two words instantly signals what we know to be true about human nature: we are often torn between an altruistic desire to be generous and a more basic instinct to gather and preserve.

For individuals and families whose wealth has grown to be intergenerational—beyond the amount they are likely to spend in their own lifetime—the process of transferring away that wealth is as philosophical as it is practical.

Employing a process to clarify and delineate philosophical and practical considerations can bring personal satisfaction and ultimately successful execution when contemplating a gifting strategy. The goal of the process is to adopt a stewardship mindset that strikes a balance between "generosity" and "financially sound implementation," resulting in effective and impactful wealth transfer.

Three Steps to Demystify Your Gifting Strategy

1. **Be Practical:** Calculate your ability to make gifts using quantitative tools to project cash flows, net worth, estate taxes.

2. **Be Purposeful:** Consider and determine the "who" "why" "what" and "how" questions of the gift.

3. **Be Tax Aware:** Consider the ever-changing tax laws, charitable deductions, and gifts that are excluded from the gift tax regime.

First, Be Practical

The initial task in considering making gifts is to identify *how much one can afford to give*, also known as "excess capacity." Rather than assigning an arbitrary fraction of one's net worth, individuals considering a transfer of wealth should engage with their advisors in two exercises: first, a present and future cash flow analysis; and secondly, an estate tax planning calculation.

A cash flow analysis will assemble a view of current liquid net worth together with current and future income and expenses. The objective of the cash flow analysis is to determine 1) the likelihood of sustaining one's current and future anticipated spending; and 2) the amount of net liquid assets in real terms (grown with inflation) remaining at the end of one's life expectancy.

Common Practical Considerations

- Can I afford to make gifts, and if so, how much can I afford to give away?
- Can I make these gifts while living, as a part of my estate, or a combination of both?
- What should I give away? Cash, securities, real estate, art, other assets?

An estate tax planning calculation adds the range of expected net liquid assets at the end of the cash flow analysis (typically the median value) to the value of other generally illiquid assets which may include real estate, business investments and art, among others.

To any extent that future values of those illiquid assets can be estimated, those values along with residual liquid assets comprise a probabilistic range of potential, future estate values. In aggregate, the results of the cash flow analysis and projected estate tax calculation will indicate one's capacity to make gifts both while living and at death. Additionally, the analysis will also provide a view into which assets may be available for gifting.

The following page contains examples of a hypothetical cash flow analysis that demonstrates how financial advisors will approach your wealth transfer strategy. The first chart will reflect $30MM invested conservatively (60/40 stock/bond mix) with the individual's annual expenses (inflation adjusted) taken as portfolio distributions.

A second chart represents the original $30MM net worth less the $12MM gift. This models $18MM invested conservatively (60/40 stock/bond mix) with the individual's annual expenses (inflation adjusted) taken as portfolio distributions.

Hypothetical Cash Flow Analysis

Scenario

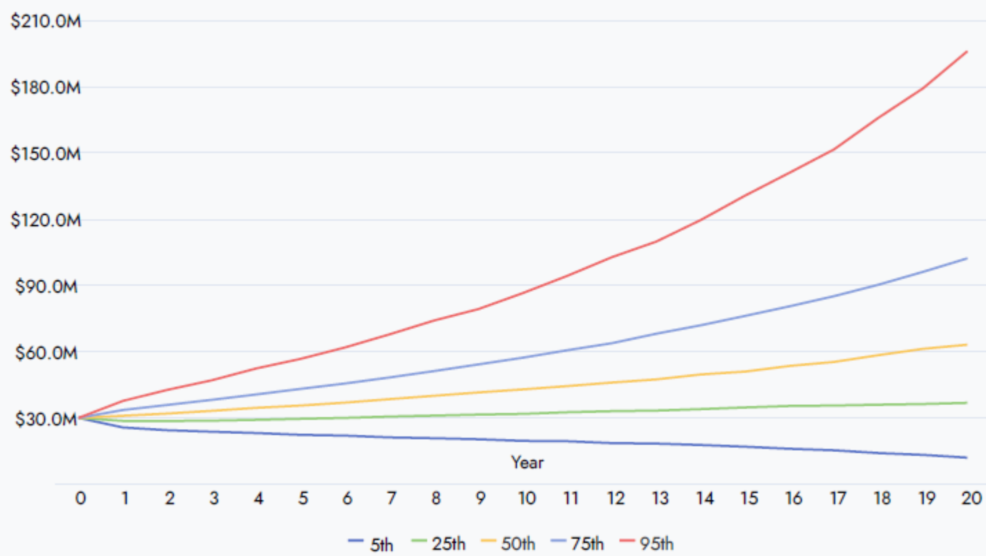
Client: Ebenezer Scrooge
Age: 65
Net Worth: $30 million
Annual Expenses: $1.2 million
Goal: Use lifetime gift and estate tax exemption (approx. $12MM) to establish trust for Tiny Tim.

Observations

The probability of depletion is effectively zero. The median case (50th percentile) shows the portfolio doubling in 20 years. Factoring growth and spending, Ebenezer has excess capacity to make gifts. But how much?

Simulated Balances

Portfolio Balances Over Time (Percentiles)



Observations

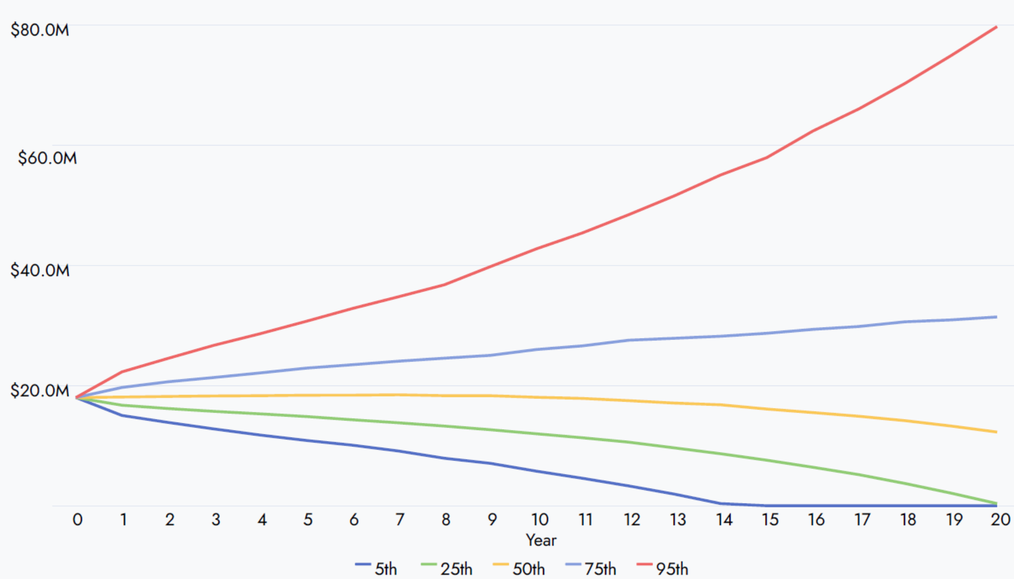
Such an outsized gift gives Ebenezer's portfolio a 24% probability of depletion. The 5th percentile of outcomes shows depletion in 14 years, and the 25th percentile of outcomes shows depletion in 20 years. The median case (50th percentile) shows the portfolio declining by 1/3 over 20 years.

Analysis

With such a significant potential of depletion, Ebenezer may want to consider alternatives to such a substantial gift today. Transfer planning is not a one-size-fits-all solution. By combining various techniques and timing Ebenezer can still meet his goals without sacrificing his own long-term security.

Simulated Balances

Portfolio Balances Over Time (Percentiles)



Second, Be Purposeful

With excess capacity identified for both *inter vivos* ("while living") and testamentary purposes, a prospective donor can next consider more philosophical aspects of giving. Donors and grantors will want to explore a number of considerations, including the scale and impact of such gifts, balancing interpersonal and charitable giving, personal values and even potentially negative consequences of giving.

Common Philosophical Considerations

- Do I want to give away any portion of my wealth?
- To whom or to which organizations do I wish to make gifts?
- What do I want to accomplish with my gifts?
- Do I wish to maximize wealth for future generations? How much do I believe future generations should receive?
- Are there specific external causes or intra-family values that are important to me, and can my giving support those?
- Are there specific assets, enterprises or investments that I wish for subsequent generations to hold?
- Are there potentially negative consequences of my gifting?

A deeper conversation around family legacy and governance can also add additional clarity to one's gifting purpose.

After identifying one's excess capacity, and then sorting through philosophical aspects of giving, a purposeful gifting intent will conform to vehicles that range from simple, one-time gifts and donations to complex strategies that accomplish multiple wealth transfer goals. Such means of giving create the opportunity to bring to life one's personal philosophies in a manner that can control for desired variables:

Outright gifts: simple and free of caveats, can be effective for achieving an immediate impact for a charity or a loved one. These gifts are nearly always irrevocable though can be made with informal or tacit provisions for interpersonal transfers and can have formalized restrictions applied for charitable transfers.

Gifts via inter vivos trusts: more complex but can add controls for timing (e.g. age attainment) and scale as well as potential to add required conditions (controls for substance abuse, employment, participation in a family business, spendthrift lifestyles, etc.). The impact of these gifts are enjoyed during the donor's/grantor's life and are most commonly irrevocable.

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Gifts via bequests or testamentary trusts: can be complex but can establish a postmortem legacy as well as can add additional controls for timing and attainment of conditions as per above. Such gifts are typically made as a part of one's legacy plans and are irrevocable.

Charitable vehicles: including Donor Advised Funds, charitable trusts as well as both public and private foundations. Creating trusts and foundations, while often complex, can provide a significant level of control but may also provide balance between philanthropic intent, interpersonal/family wealth transfer and establishment of a family legacy. (For more on DAFs and Charitable Planning Strategies, see our companion piece The In's and Out's of Charitable Giving.)

Other vehicles: including life insurance, 529 Plans for education savings, or investing to support a family member's business; these can also range from simple to complex, from structured terms to more rigid, and can be a means of controlling timing, scale or purpose of the gift. Each of these vehicles may provide degrees of revocability or irrevocability.

Third, Be Tax Aware

While most refrain from allowing the tax-tail to wag the gifting-dog, even the most altruistic of donors and grantors should consult with advisors and remain aware of the tax code. Potential grantors and donors should discuss with their advisors:

- Are strategies that seek to reduce income or estate taxes important to me?
- If so, what tax considerations may constrain or optimize my gifting intent?

Tax Considerations

- Current annual gift tax exemption amount is $16,000 per spouse, per person, per year.
- Current lifetime exemption amount is $12.06M per spouse (i.e. more than $24M per married couple to give to family / friends / heirs).
- Generation skipping transfers may be an effective strategy to reduce estate taxes but may also be subject to the Generation Skipping Tax (GST). GST is in addition to estate tax and is a separate calculation above the GST exemption, currently $12.06M per spouse.
- Medical and educational payments on a person's behalf (direct to provider) are unlimited.
- Outright, taxable gifts to family and friends in addition to the above exemption amounts are unlimited for tax purposes.
- Charitable giving is unlimited for tax purposes but deductions may be limited.

For example, if one's estate is projected to be taxable, a combination of interpersonal and charitable giving may serve as useful means for reducing or eliminating one's estate tax while also accomplishing wealth transfer and philanthropic goals. If income taxes are a present concern, strategic charitable giving can also have the added potential benefit of reducing income taxes while also building a family legacy.

Regardless of one's views on taxes relative to wealth transfer and charitable giving, our nation's tax laws are far from static, and grantors and donors should review tax considerations annually with their advisors. As a notable example, the current lifetime estate tax exemption amounts of $12.06M per spouse are due to expire and return to 2017 levels on January 1, 2026, placing those limits at roughly half of current levels. Donors and grantors presently considering making gifts should do so in consultation with their advisors to avoid missing this "use it or lose it" deadline.

Conclusion

Ebenezer Scrooge was a character study in the conflict between generosity and self-preservation, a not too subtle allegory for the burdens and responsibilities of wealth. Ultimately, though after a tortuous night of self-exploration, Scrooge discovers altruism and sets upon redeeming himself through outright gifts to those in need.

But might there have been a better way? Might have he created a trust for Tiny Tim? Might have he combined a charitable giving vehicle with interpersonal gifts to benefit his nephew? Might have he created a private foundation to serve the less fortunate? Of course not! Those strategies were not available to him, and if he had convened with his advisors to explore the philosophical and practical considerations of giving, we would have one less Dickens tale to enjoy. After all, there is little drama in happy endings where spending needs are met and legacies are established.

1. Online Etymology Dictionary. https://www.etymonline.com/word/Ebenezer#etymonline_v_958
2. Online Etymology Dictionary. https://www.etymonline.com/word/Scrooge#etymonline_v_23003

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For further insight on transfer planning and strategy, contact one of our experienced wealth advisors or explore our content library here.

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Hypothetical cash flow analysis: Stocks are proxied by the S&P 500 Index
The S&P 500 Index is a stock market index tracking the performance of approximately 500 of the largest companies listed on stock exchanges in the United States.
Bonds are proxied by the Bloomberg Barclays U.S. Aggregate Bond Index
The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS, and CMBS (agency and non-agency).
The Hypothetical Cash Flow Analysis is based on Monte Carlo analysis.
Monte Carlo simulation is a stochastic modeling technique which leverages Chilton Trust's proprietary Capital Market Assumptions (CMAs) as inputs and, assuming the returns are approximately normally distributed, performs thousands of simulated iterations which result in wide variety of potential portfolio performance outcomes.
Capital Market Assumptions (CMAs) consist of historical asset class returns, standard deviations, correlations, and yields but also take into account Chilton's forward-looking views on the markets. Actual investment results experienced may be higher or lower than forecast due to market uncertainty.
Correlation is a statistical measure of the strength of the relationship between the relative movements of two variables. More specifically in our case, the Pearson correlation coefficient measures the linear relationship between 2 sets of asset class returns. It is the ratio between the covariance of the asset class returns and the product of their standard deviations.
Standard deviation is a measure of volatility expressed as a standardized deviation from the mean. Essentially it is a measure of the dispersion or variation of a set of values. Assuming the set of values is normally distributed, 95% of the values will fall approximately within plus or minus 2 standard deviations from the mean.