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ESTATE PLANNING WITH GIFTS
BASIS CAN BITE

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INTRODUCTION

Gifting, either outright or in trust, is the most common and typically the simplest estate tax reduction strategy. The underlying basis of gifting's benefit for Federal estate tax purposes is the removal of value from the taxable estate through: (1) removal of future appreciation of, and income generated by, a gifted asset, (2) obtaining a gift value discount by restrictions on the ability to control and use or enjoy the income from the asset, or (3) reduction in gift value by deferring the donee's right to use or enjoy the income from the asset. Additionally, for the many states which have no gift tax, the present value of the gifted asset avoids state estate taxation as well.

In selecting an asset to use for gifting, the tax basis of that asset has always been considered an important planning factor. The reason for this is that an asset passing from a decedent upon death receives a new (typically increased) basis in the hands of the beneficiary (Cite). On the other hand, a gifted asset generally retains the same basis that it had in the hands of the donor (Cite). As a result, the likelihood of incurring capital gain taxes upon ultimate sale of the asset is greater for the donee of a lifetime gift than for the beneficiary of a decedent. Therefore, where there was a practical alternative, estate planners generally have avoided using highly appreciated assets for gifting purposes.

The American Taxpayer Relief Act of 2012, combined with the Affordable Care Act of 2010, have dramatically increased the potential impact of capital gains on estate planning, particularly gifting strategies. The 2012 Act increased the maximum Federal capital gain rate beginning in 2013 from 15% to 20% for higher bracket taxpayers (eg. taxable income above $400,000 for single filers and $450,000 for joint filers). (Cite). The Affordable Care Act had previously added a 3.8% surcharge beginning in 2013 on net investment income for higher income taxpayers (eg. modified adjusted gross income above $200,000 for single filers and $250,000 for joint filers). (Cite). This results in a combined Federal capital gain rate of 23.8% for higher bracket taxpayers, an increase of 8.8% over the maximum rate applying prior to January 1, 2013. (This represents almost a 60% increase in the combined Federal taxes imposed on capital gains.) And, it is worthy to note that there are proposals afloat which could increase the capital gain rate to as high as 30% (Cite). Therefore, basis has become an even greater consideration in estate planning.

<u>ILLUSTRATIONS</u>

The illustrations contained in this article quantify the somewhat surprising magnitude of the potential cost of capital gain taxes in comparison with estate tax savings when highly appreciated assets are utilized. In analyzing these illustrations, it becomes obvious that the two key factors which must be measured in every case are: (1) the proportion of an asset's present value which consists of appreciation and (2) the amount of projected appreciation during the donor's lifetime subsequent to the date of the gift (measured in terms of its value for gift tax purposes).

All illustrations are based on the gifting of a minority, non-managing member interest in a Limited Liability Company (LLC) with a present undiscounted value of $1,000,000. (Results for other values can be estimated by multiplying the figures shown in the chart by the appropriate multiple or fraction.) It is assumed that: (1) the donor's estate would be in the maximum Federal and state tax brackets; (2) a combined 35% valuation discount can be sustained both for gift and estate tax purposes, and (3) the donor and the donee are residents of New York State (a state with an estate tax and a personal income tax, but no gift tax). Various tax rate and other assumptions are contained in the notes to the chart. However, it is worth emphasizing at this point that the use of capital gain rates applicable to "high-income taxpayers" is appropriate since the sale of a valuable asset generally drives most taxpayers into such an income level.

Specifically, examining the changing results by scanning across the chart from Scenario 1 (zero basis) through Scenario 4 (basis equal to $750,000 or 75% of present value) reveals a dramatic decrease in potential "additional capital gain tax" relative to potential "estate tax savings" resulting from the illustrated gift. For example, under the assumption of 50% post-gift appreciation, the potential additional capital gain tax <u>exceeds</u> estate tax savings by $75,000 in Scenario 1 but is <u>less than</u> estate tax savings by $155,000 in Scenario 4.

Similarly, by scanning down the chart from an assumption of no post-gift appreciation to 200% post-gift appreciation also reveals a dramatic decrease in potential additional capital gain tax relative to the potential estate tax savings. For example, under Scenario 2 (basis equal to $250,000 or 25% of present value), the potential additional capital gain tax <u>exceeds</u> estate tax savings by $61,000 vacation home) may be held by a family for generations, or a gifted asset may be held long enough to pass through the donee's estate receiving a stepped up basis at that time. There are also technical tax provisions which can result in an indefinite deferral of the imposition of capital gain taxes (eg. use of donee's capital loss carryovers and deferral of recognition of gain under IRC Sec. 1231). Therefore, while it is always advisable when evaluating a proposed gifting plan to project potential capital gain taxes under the most likely scenarios, a "dollar for dollar" comparison with the projected estate tax savings should never be the sole determining factor.

A PRACTICAL APPROACH

(1) Prepare a list of a client's major assets including estimated current fair market value and tax basis.

(2) Discuss with the client, or valuation expert, the likelihood of short-term and long-term appreciation of each asset (as well as income to be generated by the asset).

(3) Make a reasonable determination of the client's life expectancy.

(4) Using the information developed in 1, 2 and 3, select a few alternative scenarios of remaining life of donor, anticipated appreciation during that remaining life and likely date of taxable disposition by the donee. Prepare projections of estate taxes and potential capital gain taxes under the selected scenarios. (If your office does not have the capability to efficiently prepare such

projections, you might want to retain an accounting firm specializing in fiduciary accounting to do so.)

(5) Weigh other factors, such as your client's non-tax reasons for transferring certain assets, and make your recommendations regarding which assets are most suitable for gifting. Remember that the two key tax considerations are: (1) the proportion of an asset's present value that consists of untaxed appreciation, and (2) the amount of anticipated appreciation of (and income to be generated by) an asset between the date of the gift and the donor's death.

SUMMARY

Potential additional capital gain taxes have always been an important consideration in evaluating a proposed gifting plan. Recent Federal tax legislation has made this consideration more vital. When weighing the advisability of gifting substantial assets, a professionally prepared projection of estate taxes and capital gain taxes is highly recommended.

where there is no post-gift appreciation but is <u>less than</u> the estate tax savings by $186,000 where post-gift appreciation is 200% of the value of the gift.

GENERAL CONCLUSION

Although many factors other than "basis" can affect a gifting strategy, it is apparent that the basis of an asset to be gifted is a vital concern. Situations in which an asset is highly appreciated and the donor's life expectancy is relatively short should particularly be scrutinized. As a "rule of thumb" (which should be utilized very cautiously), any time the basis of an asset is less than 50% of its present value and the life expectancy of the donor and economic circumstances are such that at least 50% post-gift appreciation cannot reasonably be expected, the planner should utilize another asset or another planning approach if it is at all practical. Of course, if a client's estate is expected to be fully sheltered from Federal estate tax by the available exemption, any gifting of appreciated assets should be avoided, unless there are important non-tax reasons for doing so.

A WORD OF CAUTION

The most important observation to be made regarding the impact of potential capital gain taxes on estate tax savings is that no direct comparison can be made between the two. Estate tax savings can be projected to a degree of certainty and accuracy (although the last few years of unanticipated changes in Federal gift and estate tax law cast some doubt on this assertion). There is substantially less certainty regarding the applicability and timing of capital gain taxes. The projected capital gain taxes could be incurred many years after the decedent's death or "never incurred". For example, an asset (eg. a

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