WILLS, TRUSTS & ESTATES: PLAIN AND SIMPLE

TO GIFT, OR NOT TO GIFT...

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Due to current tax laws, giving assets to loved ones ("gifting") while you are alive, in order to reduce estate taxes your heirs will need to pay on their inheritance from you, is not the 'no-brainer' it used to be. It may make sense, from a tax savings standpoint, to instead bequeath some assets upon death. This article explains why.

Income tax, gift tax and estate tax benefits can differ dramatically, depending on the income tax basis you, the giver, have in the assets to be gifted or bequeathed. Looking closely at the value of the assets may help you determine whether to gift or bequeath them.

Capital Gains Tax

The federal government and New York State impose a tax on the appreciation of an asset when sold (i.e., on the "capital gain"). This capital gains tax is imposed on the difference between the amount you paid to buy the asset and the amount for which you sell it. When you gift an asset, the recipient takes the asset with your income tax basis. In contrast, when you bequeath an asset upon your death, the income tax basis is "stepped up" to the value of the asset on your date of death. Your beneficiary takes the asset with the new stepped up basis.

The federal capital gains tax rate is currently 20%, plus 3.8% if the gain is considered "net investment income". The top New York capital gains tax rate is 8.8%. The combined federal and New York capital gains tax can total 31.5%, after taking into account the federal deductibility of state taxes and the phase out of itemized deductions.

Estate and Gift Tax Rates & Exemptions

By contrast, the top federal estate and gift tax rate is 40%. The New York estate tax rate tops out at 16%. (The 16% is imposed when the estate's value reaches over $10 million). New York has no gift tax. The NYS estate tax exemption is currently $5,250,000; the federal gift and estate tax exemption is $5,490,000.

This example illustrates the taxes that come into play when gifting or bequeathing an asset.

John and Mary have two sons, Sam and Matt. Together, John and Mary can give their sons (during life or at death) up to $10,980,000 without paying any federal gift or estate tax. John owns $6 million in stock, and his basis in the shares is $600,000. John and Mary together own another $4 million in assets. John and Mary want Sam and Matt to own the stock. Note: Assets given in the three years prior to the giver's death are subject to NYS estate tax. In 2019, this will no longer be the case.

Scenario 1 – Gift the Assets

John gifts the $6 million in stock to Sam and Matt in January 2017. There is no federal gift tax, as the value of the gift ($6 million) is under John and Mary's combined federal gift tax exemption. Sam and Matt sell the stock in April 2017 for $6 million. Tragically, both John and Mary die in 2017; John in June and Mary in July.

Tax Consequences

Federal Gift Tax $0
(gift is below the federal tax exempt limit)
NYS Estate Tax $510,800
(tax on the $6 million gift)
Capital Gains Tax $1,701,000
(31.5% x $5,400,000 stock appreciation)

Total Tax $2,211,800

Scenario 2 – Bequeath the Assets

John and Mary retain the stock until Mary dies in July 2017. They bequeath the stock to Sam and Matt under Mary's Will. Sam and Matt sell the stock in August 2017 for $6 million.

Tax Consequences

Federal Estate Tax $0
(estate is below the federal tax exempt limit)
NYS Estate Tax $1,067,600
(tax on the $10 million estate)
Capital Gains Tax $0
(stock's stepped up value is $6 million)

Total Tax $1,067,600

Assuming the stock did not appreciate significantly in value between the date of the gift and John's death, from an overall tax perspective, it would be better for John and Mary to retain the stock until they both die, rather than gift it to Sam and Matt. On the other hand, if John expects his stock to quickly and dramatically increase in value before his death (which may call for consideration of sophisticated estate planning techniques), it may be best from an estate tax perspective for John to gift the stock before his death to Sam and Matt.

Had John placed $5,250,000 of the stock in a credit shelter trust for Mary, no estate tax would have been due in either of their estates. More on this in next month's column.

As you can see, determining whether or not to make a substantial gift involves many considerations, which are more difficult to assess in these uncertain economic times.

If there is a trusts and estates topic that you would like to know more about, please feel free to email me at pmarcin@farrellfritz.com and I will do my best to cover it in a future column. My previous columns are available on www.farrellfritz.com.

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