Decisions, Decisions

Many Factors Go Into Deciding When To Transfer Wealth

A critical estate planning decision is whether to transfer wealth during your lifetime or keep your assets in your estate and transfer your wealth to loved ones after your death. Some say it would be wise to make gifts now to take advantage of the inflation-adjusted $12.06 million gift and estate tax exemption. (Without action from Congress, the exemption amount will be halved after 2025.)

Others caution that giving away wealth during one's lifetime isn't right for everyone. Let's take a closer look at factors to consider when making the decision.

Carryover Tax Basis And Stepped-Up Basis

The primary advantage of making lifetime gifts is that by removing assets from your estate you shield future appreciation from estate taxes. But there's a tradeoff: Your beneficiary receives a "carryover" tax basis — that is, he or she assumes *your* basis in the asset. If a gifted asset has a low basis relative to its fair market value (FMV), then a sale will trigger capital gains taxes on the difference.

An asset transferred at death, however, receives a "stepped-up basis" equal to its date-of-death FMV. That means the recipient can sell it with little or no capital gains tax liability. So, the question becomes, which strategy has the lower tax cost: transferring an asset by gift (now) or by bequest (later)?

The answer depends on several factors. They include the asset's basis-to-FMV ratio, the likelihood that its value will continue appreciating, your current or potential future exposure to gift and estate taxes, and the recipient's time horizon — that is, how long you expect the recipient to hold the asset after receiving it.

3 Examples

To keep things simple, let's always assume that you and your heirs are subject to tax on capital gains at a rate of 23.8% (the top capital gains rate of 20% plus the 3.8% rate on net investment income) and that the gift and estate tax rate is 40% of amounts in excess of the applicable exemption.

Example #1. You have $8 million in publicly traded securities with a $3 million basis and $2 million in other assets. You haven't used any of your exemption amount. If you give the securities to your son, who sells them immediately, he'll owe $1.19 million in capital gains taxes [23.8% × ($8 million - $3 million)]. Suppose, instead, that you hold the securities for life, that the inflation-adjusted exemption in the year you die is $12 million, and that the securities' value has grown to $13 million. If your son inherits the securities, he'll receive a stepped-up basis of $13 million and can sell them tax-free. Your estate will be subject to estate taxes of $400,000 [40% × ($13 million - $12 million exemption)]. In this scenario, holding the securities is the better strategy from a tax perspective.

Example #2. Same facts as in the first example, except that your son plans to hold the securities for life rather than sell them. In this scenario, gifting the securities now is the better strategy because, by holding them, your son avoids capital gains taxes and there's no estate tax because all future appreciation is removed from your estate.

Example #3. Again, the same facts as in the first example, except that when you die the exemption has dropped to $6 million, so your estate is subject to estate taxes of $2.8 million [40% × ($13 million - $6 million exemption)]. In this scenario, gifting the securities now results in a substantially lower tax bill, even if your son sells them immediately.

Other Real-World Factors

The previous three examples are highly simplified to illustrate the decision-making process. In the real world, many other factors may affect the overall economics, including an asset's income-earning potential, the applicability of state income and estate taxes, and potential changes in capital gains and gift and estate tax rates. Contact your estate planning advisor for more information.

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