CAPTRUST

To Gift or Not to Gift, That Is the Question

By Bruce Paulson, CPA, JD, CFP®; Jennifer Arps, CFP®; and Will Froelich, CFA
April 5, 2019

To gift or not to gift, that is the question. It is less complex than the famed question posed by Prince Hamlet, but still not a simple one for families that hold appreciated assets and are (or may be) exposed to estate tax. Not gifting means keeping the asset or doing something to cause the asset to be included in an estate for estate tax purposes. Gifting means the opposite: making a lifetime transfer to remove the asset and future appreciation from an estate to save estate tax.

Why the dilemma? It is because death brings with it one tax blessing: an income tax cost basis step-up on all assets included in an estate. For example, if you have a $1 million gain in Apple stock and you die, the gain is erased to $0. What would have been sold yesterday at a tax cost of nearly $250,000 ($1 million x 25 percent) can be sold after you die for a tax cost of $0. This makes it appealing to tempt estate tax fate and hold as much in your taxable estate as possible. The risk, of course, is fate not being on your side, causing you to end up with more estate taxes than originally planned. In the world of estate taxes, "the slings and arrows of outrageous fortune" can hit unexpectedly hard and fast.

This brief analysis looks at the basic income, gift, and estate tax arithmetic that clients may find useful as they contemplate the question: To gift or not to gift?

Why Now?

There are several reasons why the timing might matter. First, the new 2018 tax law doubled the federal estate tax exemption from $5.6 million to $11.2 million per individual ($22.4 million exemption for a married couple) for decedents passing before 2026. On January 1, 2026, the exemption will return to the pre-2018 exemption levels ($5.6 million per person, adjusted for inflation) unless Congress acts to extend the new exemption amounts. Second, with many assets appearing rich in price, what you give and how you give it matters far more than first meets the eye.

What Inputs Should Be Considered?

There are about 20 numeric inputs and assumptions. The question of whether to gift or keep can generally be answered with arithmetic, but what good are formulas when some of the most sensitive inputs are dependent on an ever-changing political landscape (e.g., capital gains rate, estate-gift tax rate, estate-gift tax exemption, etc.)? These have enormous implications to financial models and, in the blink of an eye, can change the entire analysis. Instead, the following are a few recommended guidelines from the experts.

Rules of Thumb

- **The more an asset is subject to estate tax (value exceeds exemption), the more appealing it is to gift the asset.** It is reasonable to assume the estate tax rate will remain higher than the capital gains tax rate for the foreseeable future. Assuming this is the case, gifting assets subject to estate tax is more appealing.

- **The higher the amount of unrealized gain, the more appealing it is to retain the asset.** This speaks for itself. The higher gain means a bigger step-up and, therefore, a bigger tax benefit when the gain is erased.

- **The higher the expected return on the assets, the more appealing it is to gift.** Ditto what is said in the first rule. Higher returns drive higher values, which makes gifting appealing in a taxable estate scenario.

- **The longer the time horizon, the better it is to gift.** More time means more time to grow and, hence, a higher value subject to estate tax at death.

- **The longer an asset is held after it is inherited the more appealing it is to gift.** The longer an asset is held, the longer it is until the tax liability associated with a sale is paid. Therefore, the present value of the cost is less. Assets held for generations (emphasis on plural) may never incur capital gains tax, and, if perpetuity is part of the assumptions, gifting is usually the answer.

- **Geography matters.** Where you reside matters greatly. Residents of high-tax states like Minnesota, New York, and California have more to think about than residents of Nevada or Arizona, both in terms of income taxes today and, in the case of states like Minnesota, state-level estate taxes in the future.

Example – No State Estate Tax

Imagine Juliette, single, age 80, holds $10 million worth of low-basis securities with a combined income tax basis of $6 million. Her remaining estate-gift tax exemption is $11.2 million. Assuming the exemption amount sunsets in 2026, it will return to $5.6 million. She asks whether it makes sense to gift her low-basis securities to family now, growing at 7 percent, or retain to obtain the step-up at death. Importantly, Juliette is a resident of Nevada, where there is no state estate or income tax.

Using these assumptions, but varying a) unrealized gain percent and b) life expectancy, holding the asset into the estate is the better option after all tax outcome in most scenarios. As you can see in Figure One, there is a relatively low amount subjected to estate tax in comparison to the amount exposed to capital gains tax. As an example, $10 million, with unrealized gain equal to 40 percent over four years ($6 million cost basis), grows to a value of $13.1 million. At death, $1.9 million ($13.1 million minus $11.2 million) is exposed to estate tax and multiplied by 40 percent, equaling $760,000 of tax. Alternatively, had it been gifted, the $13.1 million would have a gain of $7.1 million ($13.1 million minus $6 million) multiplied by 24 percent, equaling capital gains tax of $1.7 million. Under these circumstances, Juliette's heirs would be $940,000 better off ($1.7 million minus $760,000), upon her death, by keeping the asset in her estate today (not gifting).

Figure One: $10 Million Hold into Estate: Better and Worse

	$10MM Hold into Estate: Better(Worse)					
	Unrealized Gain %					
	0%	20.0%	40.0%	60.0%	80.0%	100.0%
2021	248,160	728,160	1,208,160	1,688,160	2,168,160	2,519,931
2023	(17,274)	462,726	942,726	1,422,726	1,902,726	2,382,726
2025	(321,169)	158,831	638,831	1,118,831	1,430,750	2,078,831
2026	(2,729,250)	(2,249,250)	(1,769,250)	(1,289,250)	(809,250)	(329,250)

Source: CAPTRUST Research

Example – State Estate Tax

Now, as shown in Figure Two, let's consider the numbers when Juliette is a resident of Minnesota and exposed to a high state estate tax (16 percent rate on amounts above $2.7 million). Notice how the presence of another layer of estate tax eliminates or reduces the benefit of keeping assets in her estate. Assuming a time horizon of more than a few years, her cost basis would need to be nearly $0 (100 percent gain) to make holding anything in her estate worth it. The estate tax is too big of a hurdle, and gifting should be given heavy consideration.

Figure Two: $10 Million Hold into Estate: Better and Worse, including Minnesota Estate Tax

	$10MM Hold into Estate: Better(Worse) - Including MN Estate Tax					
	Unrealized Gain %					
	0%	20.0%	40.0%	60.0%	80.0%	100.0%
2021	(1,151,680)	(671,680)	(191,680)	288,320	768,320	1,248,320
2023	(1,682,547)	(1,202,547)	(722,547)	(1,106,547)	(626,547)	717,453
2025	(2,290,337)	(1,810,337)	(2,194,337)	(850,337)	(370,337)	109,663
2026	(4,321,297)	(3,661,297)	(3,001,297)	(2,341,297)	(1,681,297)	(1,021,297)

No Exemptions Remaining or Gift Tax Is a Factor

What if Juliette has already used her $11.2 million exemption and still holds highly appreciated assets in her estate? What if the value of assets far exceeds the annual exemption amount and gift taxes need to be incorporated? This further complicates the analysis and, as such, is beyond the scope of this analysis. In general, the absence of an estate tax exemption levels the playing field, and both percentage of unrealized gain and future expected return become very important. When gifting desires far exceed the exemption amount, future expected return remains important, but time horizon is arguably the most important. The models built for this analysis can handle these assumptions, and CAPTRUST is happy to assist in building a custom-to-you model that makes sense.

Additional Considerations

- **Gift selection** – Being choosy and deciding what to give is key in any effective strategy. Gifting high-cost basis assets (low percent unrealized gain) with good growth potential remains appealing, as does gifting assets with long time horizons.

- **Time** – Focus on the timeline. For young clients or assets that will be held long after death, gifting is a good strategy. What does this mean for planning? Start gifting programs now and don't wait until estate taxes become a problem.

- **Grantor retained annuity trusts** – Consider using grantor retained annuity trusts to shelter asset growth from estate tax but cause the asset to be included in an estate should a passing happen during the term of the trust—in other words, when death happens sooner than originally planned for.

- **Hedging to manage concentration risk** – Maintaining a concentrated position to preserve a cost basis step-up at death does not come without risk. It is possible to hedge downside risk, but the cost of hedging should be compared to the tax savings that come with the basis step-up.

- **Creative use of debt** – Consider using debt to gift cash today, thereby keeping low-basis assets in an estate. The right circumstance for this strategy is when a client does not have a long life expectancy. Lending can be done in combination with a hedging transaction, but further discussion is beyond the scope of this article.

- **Creative portfolio construction** – Consider using a custom separate account equity index portfolio as a way to reduce the income tax liability in moving a portfolio from one or several securities into a more diversified equity portfolio.

Families should run the numbers to see whether a lifetime gifting program makes sense. Lifetime spending needs, future market assumptions, projected lifetimes, and preparedness of the next generation are just a few of the many non-tax assumptions that need to be considered. Hamlet is a classic tragedy. Improperly gifting your estate would create a modern-day tragedy.