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Estate Planning and Tax Basis: Don't Miss Out On an Opportunity

It is important for folks to understand that by doing this they may be giving up the stepped-up basis at death. Consequently, they may have missed out on an arbitrage opportunity by failing to evaluate the capital gains tax versus the inheritance tax savings.

By **Amy Neifeld Shkedy and Rebecca Rosenberger Smolen** | March 04, 2019

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As part of estate planning, most our clients are focused on how to pass assets to the next generation, while minimizing the tax burden. We have found that some individuals, in seeking to avoid potential inheritance and estate taxes, give away a portion of their assets during their lifetime (whether to their children or others) in order to minimize the size of their taxable estate at death and, thus, eliminate a substantial portion of those taxes. While

this approach certainly sounds appealing, it is important for folks to understand that by doing this they may be giving up the stepped-up basis at death. Consequently, they may have missed out on an arbitrage opportunity by failing to evaluate the capital gains tax versus the inheritance tax savings.

In Pennsylvania, unlike many other states, we still have an inheritance tax at death, so if a decedent died as a resident of Pennsylvania, the assets in his estate are taxed at death. The Pennsylvania inheritance tax rates vary depending on the relationship of the recipient of the inheritance. Assets passing to the following recipients are taxed at the following rates: spouse, 0 percent; lineal descendants/ascendants, 4.5 percent; siblings, 12 percent and others, 15 percent. There is no “exemption” or “threshold” with respect to the Pennsylvania inheritance tax, so assets are taxed at the first dollar (after a reduction for any administration expenses, funeral expenses and debts, of course). In addition to the Pennsylvania inheritance tax, there is a federal estate tax on assets passing at death (this is unified with the federal gift tax for lifetime gifts), however, this 40 percent tax is not imposed unless the assets being transferred exceed the exemption amount, which is at an all-time high of $11.4 million (or $22.8 million for a married couple).

Many individuals decide to gift assets to their children while they are still living. They may give away marketable securities, cash or even the deed to their house. For federal gift and estate tax purposes, if the assets transferred exceed the annual gift tax exclusion amount ($15,000 per donee, or $30,000 per donee from a married couple) for any given year, technically the gift would need to be reported on a federal gift tax return in order to document the use of a portion of the $11.4 million exemption by the amount of the gift. For many individuals whose assets will never reach the $11.4 million exemption at death, this is simply a reporting requirement issue and will not have a tax effect for estate tax purposes. However, for wealthier individuals who will have a taxable estate at death, this will reduce the $11.4 million federal estate tax exemption

available for remaining assets at death by the amount of the gift in excess of the annual gift tax exclusion, on a dollar for dollar basis. In Pennsylvania, there is no gift tax, so gifts can be made freely during lifetime without incurring any Pennsylvania gift tax and without any Pennsylvania reporting obligation, unless the gifts are made within a year of death (Pennsylvania only taxes assets at death through the inheritance tax).

These lifetime gifts can significantly reduce inheritance and estate taxes. In Pennsylvania, since there is no gift tax, the full amount of the lifetime gift will be removed from the taxable estate and not incur any future inheritance tax as long as the gift was made more than one year before death. Furthermore, any future appreciation on the gifted assets will also be removed from the donor's taxable estate for Pennsylvania inheritance tax purposes. For federal estate tax purposes, for gifts other than annual exclusion gifting (i.e., gifts over the $15,000 per donee annual exclusion gift tax amount), it's generally just the future appreciation that is being removed from the decedent's taxable estate since the estate and gift tax are in a unified system and the gift would reduce the available exemption at death.

Before rushing into lifetime gifting for noncash assets, it's important to consider another tax— the capital gains tax. Although the gift itself will not trigger any capital gains tax, when the recipient of the gift later sells the asset, a capital gains taxable event will occur upon sale. In order to calculate the capital gains tax, we must know what the tax cost or basis is. When a gift is made, the recipient of the gift will receive the assets with a "carry over" basis or tax cost, meaning that the original basis in the hands of the donor will "carry over" to the donee of the gift (the tax basis does not change). The amount of the capital gains tax is calculated based on the difference between the carry over basis (i.e., the original purchase price that the donor of the gift paid) and the sales price. For example, if the asset that was gifted was 1,000 shares of ABC stock, which was purchased by the donor at $50 per share, so that the

total value is $50,000, and this is transferred to a donee who later sells the stock at $150 per share with a total value of $150,000, then the capital gain at the time of sale is $100,000 (i.e., $150,000-$50,000). The donee would need to pay a capital gains tax on that $100,000 amount, which can be a 15 to 20 percent federal tax and a 3.07 percent Pennsylvania tax. That’s up to $23,000 in capital gains tax versus a $4,500 Pennsylvania inheritance tax (the 4.5 percent lineal descendant rate) had the asset been retained until death. If the asset was retained until death, then a Pennsylvania inheritance tax would be due, however, the basis or tax cost would be “stepped up” at death to the $150 per share (i.e., the fair market value at death), so that if the asset is then sold, there would be no capital gains tax. In hindsight, the donor would have been better off holding this asset until death.

For those individuals whose estates are under the federal estate tax exemption amount of $11.4 million, it’s pretty straightforward that for highly appreciated assets or, said in a different way, assets with low basis, retaining those assets until death is more beneficial from a tax perspective. This benefit is amplified in states that do not have an inheritance tax at all, such as Florida. For those ultra-wealthy individuals who fall within the federal estate tax regime, where tax will be paid at a 40 percent rate (and the gift and estate tax are unified), there needs to be a more careful analysis, and the result will depend on how much the asset appreciates between the date of the gift and the date of death.

All of this being said, when deciding to make a gift of a particular noncash asset with significant built-in gain, it’s impossible to predict the value of that asset at death. Hindsight is indeed 20/20. Even if we think we can come close to predicting an asset’s future value, the decision to gift an asset during life or retain it until death is not always about what will achieve the best tax result. Many of us want to see the next generation enjoy the use of assets while we

are living and let them spend down our inheritance now rather than later. Of course, if we are going to do that, it doesn’t hurt to give away our high basis assets first!

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