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Siller & Cohen
Family Wealth Advisors

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Since 2001, several federal tax laws have changed, which, when looked at together, have dramatically changed the focus of estate planning for many families. The most significant changes include:

- An increase in the Federal estate tax exemption from $675,000 per person to $5,430,000 per person in 2015, increasing each year thereafter for inflation.
- A decrease in the top Federal estate tax rate from 55% to 40% over that same time period.
- An increase in the top Federal long term capital gains tax rate from 15% to 23.8%.
- The advent of a concept known as "portability", which allows a surviving spouse to have the benefit of the unused portion of a deceased spouse's Federal estate tax exemption for Federal estate and gift tax purposes.

These significant changes create new factors to consider in planning, as the old estate planning adage "When in doubt, gift it out", may no longer apply.

Federal Estate Tax Concerns

The increase in the Federal estate tax exemption alone is expected to eliminate Federal estate taxes for 99.8% of all estates, thus only 2 out of 1,000 people who die are projected to owe any estate tax, according to the Joint Committee on Taxation.

For those individuals with estates over $5,430,000 (or married couples with combined estates over $10,860,000), only estate assets in excess of these amounts will be subject to Federal estate tax, and, at the lower 40% rate.

Thus, capital gains tax and state estate tax planning take on significantly greater importance.

Capital Gain "Step Up"

Federal rules have long had a concept known as a "step up" in basis. This automatically increases the *cost basis* of an asset, which would otherwise be subject to long term capital gains tax if it were sold during a person's lifetime, to its full fair market value as of the date of the owner's death.

To illustrate:

If you purchased stock many years ago for $250,000 and you sold it today for $600,000 (that is, you sold it while you were still alive), this would result in the profit of $350,000 being subject to capital gains tax. At a Federal long term capital gains tax rate as high as 23.8%, this would mean **a tax of $83,300**.

Equally, if you gift the stock while you are still alive, whether to an individual or to most trusts, and it is thereafter sold for $600,000, the same $83,300 in capital gains tax would be due. This is because the person (or trust) to whom you gave the stock receives it with the same cost basis that you had, in our example, $250,000. This is called a *carryover basis*.

[1]Licensed, not practicing

But, if you didn't sell or gift the stock while you were alive, and instead continued to own it until your death, then upon your death the stock would receive a step up in basis to the value of the stock on the date of your death, in our example, $600,000. This means that the stock could be sold by your heirs the day after you die and pay **no capital gains tax**.

What does all this this mean? For a single individual with an estate that is not expected to grow beyond $5,430,000, or a married couple unlikely to have their assets grow beyond $10,860,000 (both inflation adjusted) it likely makes sense to neither sell nor gift the assets while alive, but instead to hold onto their assets until they die. If they do, then (1) the assets will not be subject to federal estate tax, and (2) their heirs will receive the assets with a stepped up basis, and will be able to sell them without paying the capital gains tax that would otherwise be due on the difference between the $250,000 and $600,000.

What about estates above the $5,430,000 (single) or $10,860,000 (married)? The answer is, it depends, and state income taxes and state estate taxes may create the swing vote.

State Taxes – The Swing Vote

Nineteen states and the District of Columbia levy an *estate* tax and/or an inheritance tax. Most states have an exemption significantly lower than the $5,430,000 Federal estate tax exemption. The states we are most often asked about are:

State	2015 Exemption	Top Rate
Connecticut	$2,000,000	12%
Delaware	$5,430,000	16%
New Jersey	$675,000	16%
New York	$3,125,000	16%
Florida	No Estate Tax	NA

Note that New York's exemption is going up each year until it catches up to the Federal exemption in January 2019. That's the good news. The bad news is that New York has what is known as a "cliff". That means that if your estate is greater than 105% of the New York exemption in the year of your death, your estate will lose the benefit of the New York Exemption *completely*, and all of your assets will be subject to New York estate tax back to the *first dollar*.

Note also that Connecticut has one of the nation's only remaining state *gift* taxes.

State *income* taxes need to be taken into account as well. To illustrate: An individual residing in New York City wishes to determine if he/she is better off gifting long term capital gain assets, or holding on to them until he/she dies to take advantage of the step up in basis. He/she is subject to the Alternative Minimum Tax (which means that state and local income taxes are not deductible against Federal income taxes), and is otherwise subject to all of the top tax rates. Thus the maximum combined effective Federal and New York estate tax rate is 49.6 %, and the combined effective Federal and New York long term capital gains tax rate is 36.5%. Assuming that all of their assets are long term capital gain assets that have appreciated 70% over the years, the following matrix suggests when he/she should consider gifting, and when he/she should consider keeping their assets.

Estate Size	Combined Federal & NY Estate Tax	Combined Federal & NY Cap Gains Tax	In Favor Of Gifting
$5,000,000	$391,600	$1,277,500	No
$10,000,000	$2,468,560	$2,555,000	No
$20,000,000	$7,428,080	$5,110,000	Yes
$50,000,000	$22,308,080	$12,775,000	Yes
$100,000,000	$47,108,080	$25,550,000	Yes

The above chart is necessarily based on many assumptions that may not apply to your situation. The chart is simply meant to illustrate how the change in these tax laws can turn traditional estate planning on its head. State income and state estate taxes are often the swing vote, and thus your state of residence has a dramatic impact on the numbers.

Note also that the chart does not take into account cash flow needs, which is a critical factor in a person's determination whether or not to make estate planning gifts.

Trusts - The Best of Both Worlds?

Making lifetime gifts to an irrevocable trust outside of your taxable estate can provide the best of both worlds. As noted above, for capital gains tax purposes, lifetime gifts to most trusts are treated the same way as lifetime gifts to individuals, that is, the recipient trust receives a *carry over* basis in the gifted asset. Thus, a later sale by the trust would result in the same recognition of capital gains as the person who made the gift would have recognized if he or she had sold it before death.

So how can a trust avoid the complex analysis above to determine whether long term capital gain assets should be gifted, or kept in the estate to receive a step up in basis?

Let's assume that 10 years ago you owned stock with a cost basis of $1M, and at that time you (1) created a grantor trust and reserved to yourself a "power of substitution", and (2) gifted the stock to the trust. Let's assume further that the stock has appreciated to be $3M today.

If the trust were to sell the stock today, the trust would have a $2M capital gain, and would owe capital gains tax on this amount. This is because the trust received a *carry over* basis in the stock of $1M when you gifted it.

If you died today, and the trust sells the stock tomorrow, the trust *still* has a $2M capital gain; the stock doesn't receive a step up in basis at your death because you didn't *own* the stock when you died.

But, if you happen to own other assets with no built-in capital gain, cash for example, you could use your power of substitution to take the stock back from the trust, and give the trust $3M cash in exchange. Because the trust is a grantor trust, this substitution should not create a taxable event.

The result? After the substitution, you have the stock back, and the trust has cash. When you later die owning the stock, the stock will receive a "step up" in basis to its fair market value, $3,000,000 in our example, eliminating the capital gains tax on the $2M profit. In essence, you would have gotten the appreciation on the stock out of your taxable estate, and then transferred it back into your estate so your heirs could receive the stepped up basis.

Of course, the grantor needs to cooperate by living long enough for the second transfer to occur.

Conclusion

Changes in Federal and state tax rates and exemptions over the years changed the landscape of estate planning. Traditional estate planning techniques need to be re-evaluated with particular emphasis on the smaller difference between the Federal estate tax and long term capital gains tax rates, as well as the increased importance of state taxes.

ABOUT SILLER & COHEN

Siller & Cohen is a boutique family wealth advisory firm providing financial solutions for the past twenty-five years to institutions and high net worth individuals. We combine the detail and careful attention of a smaller firm with the deep resources of a national organization. Our team includes CPAs[1], Certified Investment Management Analysts, and attorneys.[1]

While we offer our clients the full range of planning services, our core areas of expertise include wealth transfer, investments, and business succession planning.

This is the 11th year in a row that Barron's Magazine has recognized a member of Siller & Cohen as being among the top advisors in the nation.[2]

[1] Licensed, not practicing
[2] The list was compiled by RJ Shook, Financial Industry Consultants.
This is an objective ranking based on assets under management.

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