Death, taxes, and upstream gifting

Blog

According to an old saying, there’s nothing certain but death and taxes. It’s true that taxes are the worst, but that doesn’t mean they’re completely inevitable. In fact, it turns out that death could actually be the cure for some taxes.

As we discussed in Give to others, not the IRS, giving low-cost basis securities to your family and friends may help you chip away at concentrated positions, and be an opportunity to reduce your capital gains taxes. Unfortunately, this also means you’ll be gifting a tax liability. That’s a social faux-pas, but it makes good financial sense; after all, this allows you to give a larger amount than if you sell the appreciated stock and give them the after-tax proceeds (see more in A Grinch’s Guide to Gifting).

There are two special cases where giving away unrealized gains can be especially effective.

Giving to the next generation
The first example is when giving shares to children. They’ll be able to defer the capital gains taxes for decades, and may face a much lower capital gains tax rate when they eventually do sell. In the meantime, there’s a tangential educational benefit, because owning stocks from an early age can teach a valuable lesson about saving, investing, and the power of compound growth.

Upstream gifting
The second special case is a bit more counterintuitive: gifting shares to your parents or grandparents. This tactic has earned the moniker “upstream gifting,” and it is designed to take advantage of a quirk of the US tax code: when you pass away, your heirs get a step-up in cost basis, which means that the unrealized capital gains taxes are essentially forgiven.

This strategy makes a bit more sense when viewed from a multi-generational family-level perspective. Let’s assume that a portion of your parents’ and grandparents’ assets are earmarked to be given to you when they die. In the context of the Liquidity. Longevity. Legacy. (3L)* framework, these assets are in their Legacy strategy but should also be considered a part of your Longevity portfolio.
Upstream gifting could help you improve your family’s after-tax returns, but the strategy comes with an important caveat for wealthy families: the estate tax (also known as the “death tax”). From now until 2025, there is a lifetime federal estate tax exemption of about USD 11.4 million (USD 22.8 million for a married couple), after which estates are taxed at a top federal marginal rate of 40%. Several states’ estate tax limits kick in at much lower levels, and apply estate taxes of their own.

These limits and rates are a moving target, and will continue to be common political targets, so estate planning is key. Bear in mind that there is an inherent tradeoff; in trying to defer and avoid paying long-term capital gains—which are now taxed at 23.8% (20% plus a 3.8% net investment income tax)—make sure that you’re not incurring a much higher probability of having those assets (cost basis plus unrealized gains) taxed at the 40% estate tax rate.

For families whose taxable estates are well below the limit, upstream gifting could be another useful tool of mitigating taxes, but it’s important to discuss specifics with your financial advisor, who can help coordinate strategies with tax and estate specialists.

*Timeframes may vary. Strategies are subject to individual client goals, objectives, and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

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Appendix

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