By **Jay D. Waxenberg** & **Nathan R. Brown**

The Narrowing "Tax Efficiency Gap"

A seismic shift in estate planning

Estate planners have traditionally crafted estate plans for their clients primarily focusing on reducing future estate tax and only tangentially considering the income tax consequences. For years, the estate tax savings that could be realized through lifetime gifting outweighed any future income tax liability resulting from such gifting. This reality was primarily due to high estate tax rates, a relatively low estate tax exemption (not indexed for inflation) and comparatively low capital gains tax rates. Recent legislative changes, however, have caused a shift in focus, with the income tax consequences of estate planning taking on greater significance. In many circumstances, the estate tax savings realized through lifetime gifting will be lost or greatly diminished by the future income tax liabilities. We'll discuss the increasing importance of basis considerations in estate planning in light of the narrowing gap between estate tax rates and income tax rates, the effects of state taxes on such planning and how post-gift asset exchanges can maximize the tax efficiency of lifetime gifts. (For a comparison of all the examples set forth in this article, see "Side-by-Side Comparison," p. 23.) In a follow-up article, we'll discuss the various asset exchange techniques that all estate planners should be familiar with.

Tax Efficiency Gap

When an individual dies owning an asset, the fair market value (FMV) of that asset on the date of the decedent's death is included in his gross estate, and any person receiving such asset takes a stepped-up basis in the asset equal to its FMV on the date of the decedent's death.[1] Conversely, when an individual gifts an asset during life, the person receiving the gifted asset takes a carryover basis equal to the donor's basis in the asset immediately prior to the gift.[2] This carryover basis, generally, is increased by the amount of gift tax, if any, paid by the donor on the transfer of the gifted asset.[3]

A primary objective of estate planning has long been to remove assets with high appreciation potential from a client's taxable estate through the implementation of lifetime gifting techniques (typically involving transfers to trusts), thus, avoiding estate tax on any post-gift/pre-death appreciation. The cost for avoiding estate tax on such appreciation is an increase in future income tax liability (generally capital gains tax) when the gifted asset is ultimately sold by the donee. This increased future income tax liability results from the donee taking a carryover basis in the gifted asset. The result is that the donee will be subject to capital gains tax on all pre-death appreciation, even appreciation occurring prior to the gift, if and when the donee sells the asset. Conversely, if no lifetime gift were made, the client would be subject to estate tax on the full FMV of the asset (including all pre-death appreciation), and the beneficiaries would receive the asset with a stepped-up basis. The effect of the stepped-up basis is that the beneficiaries won't be subject to capital gains tax on pre-death appreciation.

Accordingly, when an individual considers making a lifetime gift, the estate tax savings achieved (by removing post-gift/pre-death appreciation from the donor's gross estate) must be weighed against the future income tax liability that will be incurred by the donee (as a result of the carryover basis) when the gifted asset is sold.

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A technique commonly employed in estate planning to mitigate the income tax consequences of making a lifetime gift and take advantage of the step-up in basis at death is to have the donor exchange low basis assets gifted to a trust (the originally gifted assets) for cash or high basis assets (the exchanged assets) at a point in time close to the donor's death (which, admittedly, is often difficult to predict). For purposes of this article, a purchase or exchange of the trust's low basis assets for the donor's cash or high basis assets is referred to as a "post-gift asset exchange." As a result of making a post-gift asset exchange, the originally gifted asset (with a low basis) will be included in the donor's gross estate, thereby receiving a stepped-up basis on the donor's death, and, provided that the exchanged assets have a basis equal to their FMV, the income tax that otherwise would be owed by the donee on all pre-death appreciation in the originally gifted asset is eliminated, thereby maximizing the tax efficiency of the lifetime gift.

Historically, estate tax rates have been sufficiently higher than the capital gains tax rate. So, it's been more efficient from a tax perspective to make lifetime gifts, rather than to hold on to an asset until death to receive a stepped-up basis, even without a post-gift asset exchange. That is, the estate tax saving achieved by avoiding payment of estate tax on post-gift/pre-death appreciation generally exceeded the cost of the payment of capital gains tax on all pre-death appreciation in the gifted asset. We'll refer to the difference between the estate tax rate and the capital gains tax rate as the "tax efficiency gap." For example, in 2000, prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[4] the top federal estate and gift tax rate was 55 percent (with a non-indexed exemption of $675,000), and the capital gains tax rate was 20 percent. Due to the large 35 percent tax efficiency gap, lifetime gifts were extremely tax efficient, even without a post-gift asset exchange.

The tax efficiency gap for 2014 is only 16.2 percent.

Example 1:[5] Assume that in 2000, Andrew owned stock with an FMV of $10 million and a basis of $2 million. Assume further that at the time of Andrew's death, the stock

Side-by-Side **Comparison**

An overview of the results

	Death With Asset: Tax Due ($)	2014 Gift With No Exchange: Tax Due ($)	Tax Benefit of Lifetime Gift ($)	2014 Gift With Exchange: Tax Due ($)	Tax Benefit of Lifetime Gift With Exchange vs. Death With Asset ($)	Tax Benefit of Lifetime Gift With Exchange vs. Gift With No Exchange ($)
Federal Only	6,420,000	6,983,094.40	–563,094.40	1,864,000	4,556,000	5,119,094.40
Federal/Collectible	6,420,000	8,703,798.40	–2,283,798.40	1,864,000	4,556,000	6,839,798.40
Federal/California	6,420,000	9,843,764.80	–3,423,764.40	1,864,000	4,556,000	7,979,764.80
Federal/New York City	8,500,080	9,714,712	–1,214,632	1,864,000	6,636,080	7,850,712

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has appreciated in value to $25 million. If Andrew holds on to the stock until death, Andrew's gross estate will include the entire $25 million value of the stock, resulting in estate tax of $13,378,750. The beneficiary of the stock would receive a stepped-up basis; therefore, he would incur no capital gains tax on pre-death appreciation.

If, on the other hand, Andrew makes a gift of the stock to a grantor trust in 2000, he'll pay gift tax of $5,128,750 on the transfer. The trust will take a $6.103 million basis ($2 million carryover basis, plus $4.103 million gift tax paid on net appreciation) in the stock and pay capital gains tax of $3,779,400 on all pre-death appreciation. This scenario results in a total tax liability of $8,908,150.

Accordingly, a lifetime gift in 2000 without a post-gift tax exchange would result in a tax savings of $4,470,600. If a post-gift asset exchange is employed, the gift tax results would remain the same (that is, Andrew would pay gift tax of $5,128,750 at the time of the gift); however, the $3,779,400 capital gains tax would be eliminated.[6] Consequently, a lifetime gift in 2000 coupled with a post-gift asset exchange would result in tax savings of: 1) $8.25 million, compared to owning the stock at death, or 2) $3,779,400, compared to a lifetime gift without a post-gift asset exchange. (See "Three Pre-EGTRRA Stock Scenarios," this page.)

Three Pre-EGTRRA Stock Scenarios

In 2000, lifetime gifts were tax efficient

Scenario A:	**Stock Owned at Death**
Exemption Amount at Death	$675,000
Estate Tax Rate	55%
Estate Tax Paid	($25 million x .55) – ($675,000 x .55) = $13,378,750
Beneficiary's Basis in Stock	$25 million
Capital Gains Tax Rate	20%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .20 = $0
Total Taxes Paid	$13,378,750 + $0 = $13,378,750
Scenario B:	**Gift of Stock in 2000**
Exemption Amount at Time of Gift	$675,000
Gift Tax Rate	55%
Gift Tax Paid	($10 million x .55) – ($675,000 x .55) = $5,128,750
Trust's Basis in Stock	$2 million + $4.103 million = $6.103 million
Capital Gains Tax Rate	20%
Gain on Pre-Death Appreciation	($25 million – $6.103 million) x .20 = $3,779,400
Total Taxes Paid	$5,128,750 + $3,779,400 = $8,908,150
Scenario C:	**Gift of Stock in 2000 With Post-Gift Asset Exchange**
Exemption Amount at Time of Gift	$675,000
Gift Tax Rate	55%
Gift Tax Paid	($10 million x .55) – ($675,000 x .55) = $5,128,750
Trust's Basis in Assets After Exchange	$25 million
Capital Gains Tax Rate	20%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .20 = $0
Total Taxes Paid	$5,128,750 + $0 = $5,128,750

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The Narrowing Gap

In recent years, the tax efficiency gap has narrowed, and with the enactment of the American Taxpayer Relief Act of 2012 (ATRA),[7] the tax efficiency gap is tighter than it's ever been. With a small tax efficiency gap and a $5 million estate tax exemption indexed for inflation, there's now an increased importance placed on the income tax consequences of lifetime gifts and the use of post-gift asset exchanges to mitigate such consequences. In fact, in many situations, absent a post-gift asset exchange, a lifetime gift may prove to be less efficient from an overall tax perspective than owning the asset at death.

The historically small tax efficiency gap is primarily the result of: (1) ATRA, which "permanently" increased the estate and gift tax exemption to $5 million (indexed for inflation, annually), estate and gift tax rates to 40 percent and capital gains tax rate to 20 percent, and (2) the 3.8 percent net investment income tax (NIIT), which generally applies to passive income.

The new 20 percent capital gains tax rate applies to individuals with taxable income in excess of $400,000 ($450,000 if married and filing jointly) and trusts and estates with taxable income in excess of $12,150.[8] With respect to individuals, the NIIT is equal to 3.8 percent of the lesser of an individual's: (1) NII for the year, and (2) modified adjusted gross income for such year in excess of $200,000 ($250,000 if married and filing jointly).[9] With respect to a trust, the NIIT is equal to 3.8 percent of the lesser of the trust's: (1) undistributed NII for the year, or (2) adjusted gross income for the year over $12,150 (the dollar amount at which the highest tax bracket in Internal Revenue Code Section 1 begins).[10] NII generally includes passive types of income, such as

Three Post-ATRA Stock Scenarios

In 2014, a lifetime gift isn't tax efficient

Scenario A:	**Stock Owned at Death in 2033**
Exemption Amount in 2033	$8.95 million
Estate Tax Rate	40%
Estate Tax Paid	($25 million x .40) – ($8.95 million x .40) =$6.42 million
Beneficiary's Basis in Stock	$25 million
Capital Gains Tax Rate	20%
Net Investment Income Tax (NIIT)	3.8%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .238 = $0
Total Taxes Paid	$6.42 million + $0 = $6.42 million
Scenario B:	**Gift of Stock in 2014**
Exemption Amount at Time of Gift	$5.34 million
Gift Tax Rate	40%
Gift Tax Paid	($10 million x .40) – ($5.34 million x .40) = $1.864 million
Trust's Basis in Stock	$2 million+ $1,491,200 = $3,491,200
Capital Gains Tax Rate	20%
NIIT	3.8%
Gain on Pre-Death Appreciation	($25 million - $3,491,200) x .238 = $5,119,094.40
Total Taxes Paid	$1.864 million + $5,119,094.40 = $6,983,094.40
Scenario C:	**Gift of Stock in 2014 With Post-Gift Asset Exchange**
Exemption Amount at Time of Gift	$5.34 million
Gift Tax Rate	40%
Gift Tax Paid	($10 million x .40) – ($5.34 million x .40) = $1.864 million
Trust's Basis in Assets After Exchange	$25 million
Capital Gains Tax Rate	20%
NIIT	3.8%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .238 = $0
Total Taxes Paid	$1.864 million + $0 = $1.864 million

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gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property and passive activities. As most lifetime gifting techniques involve gifts to trusts, and the gain from the sale of the gifted asset will be NII, the new 20 percent capital gains tax rate and 3.8 percent NIIT will apply at very low thresholds.

As a result of these legislative changes, the tax efficiency gap for 2014 is only 16.2 percent (40 percent estate tax rate, less the 20 percent capital gains tax rate and the 3.8 percent NIIT), nearly 20 percentage points smaller than what it was in 2000. This dramatic narrowing will have a significant impact on planning.

> **Example 2:** Assume the same facts as in Example 1, except that the laws in effect in 2014 apply and Andrew dies in 2033. If Andrew holds on to the stock until death, his gross estate will include the entire $25 million value of the stock, resulting in estate tax of $6.42 million. The beneficiary of the stock would receive a stepped-up basis; therefore, he would incur no capital gains tax on pre-death appreciation. This estate tax liability assumes an estate tax exemption in 2033 of $8.95 million.[11]
>
> If, on the other hand, Andrew makes a gift of the stock to a grantor trust in 2014, he'll pay gift tax of $1.864 million on the transfer. The trust will take a $3,491,200 basis ($2 million carryover basis plus $1,491,200 gift tax paid on net appreciation) in the stock and pay capital gains tax of $4,301,760 and NIIT tax of $817,334.40 on all pre-death appreciation. This results in a total tax liability of $6,983,094.40.
>
> Accordingly, without a post-gift asset exchange, a lifetime gift wouldn't be tax efficient, as it would cost $563,094.40 more in total taxes to make a gift of the stock in 2014. If Andrew is unwilling or unable to make a post-gift asset exchange, he would be better off not making the gift. If a post-gift asset exchange is employed, the gift tax results would remain the same (that is, Andrew would pay gift tax of $1.864 million at the time of the gift); however, the $4,301,760 capital gains tax and $817,334.40 NIIT would be eliminated. Consequently, a lifetime gift in 2014 coupled with a post-gift asset exchange would result in tax savings of: (1) $4.556 million, compared to owning the stock at death, or (2) $5,119,094.40, compared to a lifetime gift without a post-gift asset exchange.[12] (See "Three Post-ATRA Stock Scenarios," this page.)

Unlike the case in 2000, when a lifetime gift was tax efficient even without a post-gift asset exchange, in 2014 (and for the foreseeable future), a lifetime gift, generally, won't be tax efficient unless the donor is willing and able to execute a post-gift asset exchange.

The tax efficiency gap is further narrowed, increasing the value of a post-gift asset exchange, if the asset transferred is subject to an income tax rate in excess of the 20 percent capital gains tax rate. Many clients, for

example, have large collections of artwork that they may wish to gift to their children. Unlike stock, which is subject to a 20 percent capital gains tax rate, art is considered a "collectible" and is subject to a capital gains tax rate of 28 percent, resulting in a tax efficiency gap of only 8.2 percent in 2014.[13]

Example 3: Assume that Betty owns a valuable piece of art with an FMV of $10 million and a basis of $2 million. Further assume that the art will increase in value to $25 million by the time Betty dies in 2033. If Betty holds on to the art until death, her estate will include the $25 million value of the art, resulting in estate tax of $6.42 million. The beneficiary of the art would receive a stepped-up basis; therefore, he would incur no capital gains tax on the pre-death appreciation.

If, on the other hand, Betty makes a gift of the art to a grantor trust in 2014, she'll pay gift tax of $1.864 million on the transfer. The trust will take a $3,491,200 basis ($2 million carryover basis plus $1,491,200 gift tax paid on net appreciation) in the art and pay capital gains tax of $6,022,464 and NIIT tax of $817,334.40 on all pre-death appreciation. This scenario results in a total tax liability of $8,703,798.40.

Accordingly, without a post-gift asset exchange, it would be less tax efficient to make a lifetime gift of the art, as it would cost $2,283,794.40 more in total taxes. If a post-gift asset exchange is employed, the gift tax results would remain the same (that is, Betty will pay gift tax of $1.864 million at the time of the gift); however, the $6,022,464 capital gains tax and $817,334.40 NIIT would be eliminated. Consequently, a lifetime gift in 2014 coupled with a post-gift asset exchange would result in tax savings of: (1) $4.556 million, compared to owning the art at death, or (2) $6,839,798.40, compared to a lifetime gift without a post-gift asset exchange. (See "Three Post-ATRA Collectible Scenarios," this page.)

Planning considerations will differ depending on the client's state of residence, and it's imperative that the practitioner understand the state tax consequences of each transaction.

Three Post-ATRA Collectible Scenarios

It's less effective to make a lifetime gift without a post-gift asset exchange

Scenario A:	**Art Owned at Death in 2033**
Exemption Amount in 2033	$8.95 million
Estate Tax Rate	40%
Estate Tax Paid	($25 million x .40) – ($8.95 million x .40) = $6.42 million
Beneficiary's Basis in Art	$25 million
Capital Gains Tax Rate	28%
Net Investment Income Tax (NIIT)	3.8%
Gain on Pre-Death Appreciation	($25 million – $25 million) x .318 = $0
Total Taxes Paid	$6.42 million + $0 = $6.42 million
Scenario B:	**Gift of Art in 2014**
Exemption Amount at Time of Gift	$5.34 million
Gift Tax Rate	40%
Gift Tax Paid	($10 million x .40) – ($5.34 million x .40) = $1.864 million
Trust's Basis in Art	$2 million + $1,491,200 = $3,491,200
Capital Gains Tax Rate	28%
NIIT	3.8%
Gain on Pre-Death Appreciation	($25 million - $3,491,200) x .318 = $6,839,798.40
Total Taxes Paid	$1.864 million + $6,839,798.40 = $8,703,798.40
Scenario C:	**Gift of Art in 2014 With Post-Gift Asset Exchange**
Exemption Amount at Time of Gift	$5.34 million
Gift Tax Rate	40%
Gift Tax Paid	($10 million x .40) – ($5.34 million x .40) = $1.864 million
Trust's Basis After Exchange	$25 million
Capital Gains Tax Rate	28%
NIIT	3.8%
Gain on Pre-Death Appreciation	($25 million - $5 million) x .318 = $0
Total Taxes Paid	$1.864 million + $0 = $1.864 million

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Effect of State Taxes

The above examples take into consideration only federal

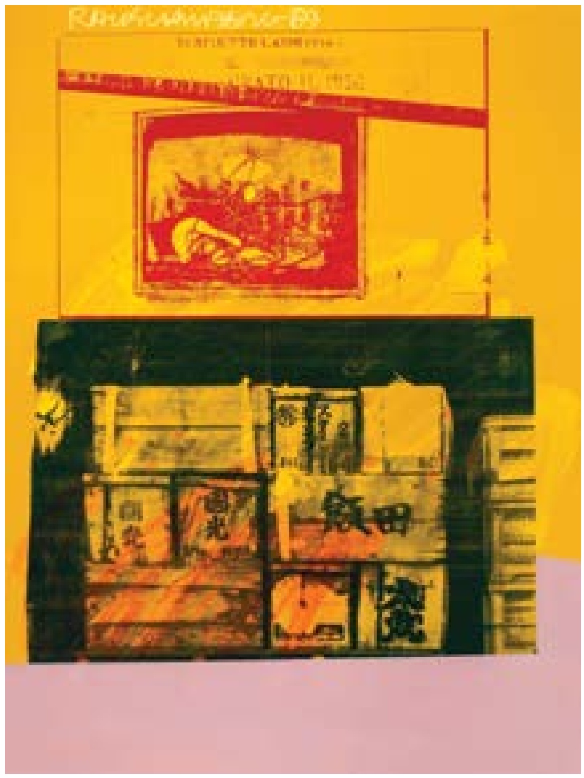
taxes and demonstrate that, in today's tax environment, simply transferring assets with high appreciation potential out of one's estate without any further action is no longer the effective tax savings technique that it once was. In fact, it can be detrimental from an overall tax perspective.

As estate planning doesn't take place in a federal vacuum, we must factor state taxes into the equation. This addition further complicates planning decisions and places an even greater emphasis on the income tax consequences of planning decisions. Planning considerations will differ depending on the client's state of residence, and it's imperative that the practitioner understand the state tax consequences of each specific transaction. To demonstrate the complications and increased importance of income tax planning amplified by state and local taxes, let's explore the respective planning considerations for a California resident and a New York City resident.

California. California has a 13.3 percent income tax rate and no estate or gift tax. As a result, the tax efficiency gap is only 2.9 percent (40 percent federal estate tax rate, less 37.1 percent federal and state effective income tax rate), making lifetime gifts without post-gift asset exchanges inefficient from an overall tax perspective.

> **Example 4:** Assume all of the same facts as in Example 2, except that Andrew is a resident of California. If Andrew holds on to the stock until death, his gross estate will include the entire \$25 million value of the stock, resulting in federal estate tax of \$6.42 million and no state estate tax. The beneficiary of the stock would receive a stepped-up basis; therefore, he would incur no capital gains tax on pre-death appreciation.
>
> If, on the other hand, Andrew makes a gift of the stock to a grantor trust in 2014, he'll pay federal gift tax of \$1.864 million and no state gift tax on the transfer. The trust will take a \$3,491,200 basis (\$2 million carryover basis plus \$1,491,200 gift tax paid on net appreciation) in the stock and will be subject to tax on all pre-death appreciation at an effective combined federal and state rate of 37.1 percent,[14] resulting in an income tax liability of \$8,108,817.60. This scenario results in a total tax liability of \$9,972,817.60.

Accordingly, without a post-gift asset exchange, a lifetime gift wouldn't be tax efficient, as it would cost \$3,423,764.80 more in total taxes to make a gift of the stock in 2014. If a post-gift asset exchange is employed, the gift tax results would remain the same (that is, Andrew would pay gift tax of \$1.864 million at the time of the gift); however, the \$8,108,817.60 combined income tax would be eliminated. Consequently, a lifetime gift in 2014 coupled with a post-gift asset exchange would result in tax savings of: (1) \$4.556 million,



SPOT LIGHT

Who Ordered Takeout?
"Story Crates" (48 3/4 in. by 36 3/4 in.) by Robert Rauschenberg, sold for \$100,000 at Heritage's recent Modern and Contemporary Art Auction in Dallas on May 31, 2014. A prominent Neo-Dadaist, along with Jasper Johns, Rauschenberg strongly believed in the role of the observer in creating art's meaning.

compared to owning the stock at death, or (2) $8,108,817.60, compared to a lifetime gift without a post-gift asset exchange. (See "California Considerations," this page.)

As the above example illustrates, states that have high state income taxes and low or no state estate tax, such as California, will tend to have very small tax efficiency gaps. Therefore, lifetime gifts by residents of these states will, generally, be very inefficient from an overall tax perspective.

California Considerations

A high income tax and low estate estate tax result in a small tax efficiency gap

Scenario A:	**Stock Owned at Death in 2033**
Exemption Amount in 2033	$8.95 million
Estate Tax Rate	40%
Estate Tax Paid	($25 million x .40) – ($8.95 million x .40) = $6.42 million
Beneficiary's Basis in Stock	$25 million
Capital Gains Tax Rate	20%
Net Investment Income Tax (NIIT)	3.8%
California Income Tax Rate	13.3%
Effective Rate	37.1%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .371 = $0
Total Taxes Paid	$6.42 million + $0 = $6.42 million

Scenario B:	**Gift of Stock in 2014**
Exemption Amount at Time of Gift	$5.34 million
Gift Tax Rate	40%
Gift Tax Paid	($10 million x .4) – ($5.34 million x .4) = $1.864 million
Trust's Basis in Stock	$2 million + $1,491,200 = $3,491,200
Capital Gains Tax Rate	20%
NIIT	3.8%
California Income Tax Rate	13.3%
Effective Rate	37.1%
Gain on Pre-Death Appreciation	($25 million - $3,491,200) x .377 = $8,108,817.60
Total Taxes Paid	$1.864 million + $8,108,817.60 = $9,972,817.60

Scenario C:	**Gift of Stock in 2014 With Post-Gift Asset Exchange**
Exemption Amount at Time of Gift	$5.34 million
Gift Tax Rate	40%
Gift Tax Paid	($10 million x .40) – ($5.34 million x .40) =$1.864 million
Trust's Basis in Assets After Exchange	$25 million
Capital Gains Tax Rate	20%
NIIT	3.8%
Gain on Pre-Death Appreciation	($25 million – $25 million) x .238 = $0
Total Taxes Paid	$1.864 million + $0 = $1.864 million

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New York. New York has a state income tax of 8.82 percent, and New York City has a local income tax of 3.88 percent, resulting in a combined federal, state and local effective income tax rate of 36.5 percent on capital gains.[15] Additionally, unlike California, New York has a state estate tax of 16 percent (with a $1 million non-indexed exemption), resulting in a combined federal and state effective estate tax rate of 49.6 percent. As a result, the tax efficiency gap for a resident of New York City is 13.1 percent, more than California, but less than the 20 percent tax efficiency gap that applies at the federal level. Therefore, lifetime gifts without post-gift asset exchanges by a New York City resident will be more efficient than those made by a California resident, but less efficient than those made by a resident of a state that has low or no state income tax, such as Florida.

Example 5: Assume all of the same facts as in Example 2, except that Andrew is a resident of New York City. If Andrew holds on to the stock until death, his gross estate will include the entire $25 million value of the stock, resulting in federal estate tax of $5,033,280 and state estate tax of $3,466,800, for a total estate tax liability of $8,500,080. The beneficiary of the stock would receive a stepped-up basis; therefore, he would incur no capital gains tax on pre-death appreciation.

If, on the other hand, Andrew makes a gift of the stock to a grantor trust in 2014, he'll pay federal gift tax of $1.864 million and no state gift tax on the transfer. The trust will take a $3,491,200 basis ($2 million carryover basis plus $1,491,200 gift tax paid on net appreciation) in the stock and will be subject to tax on all pre-death appreciation at an effective combined federal, state and local rate of 36.5 percent, resulting in an income tax liability of $7,850,712. This scenario results in a total tax liability of $9,714,712.

Accordingly, without a post-gift asset exchange, a lifetime gift wouldn't be tax-efficient, as it would cost $1,758,920 more in total taxes to make a gift of the stock in 2014. If a post-gift asset exchange is employed, the gift tax results would remain

the same (that is, Andrew would pay gift tax of $1.864 million at the time of the gift); however, the $7,850,712 combined income tax would be eliminated. Consequently, a lifetime gift in 2014 coupled with a post-gift asset exchange would result in tax savings of: (1) $6,636,080, compared to owning the stock at death, or (2) $7,850,712, compared to a lifetime gift without a post-gift asset exchange. (See "New York Considerations," this page.)

Endnotes

1. Internal Revenue Code Sections 2031, 2033 and 1014.
2. IRC Section 1015. If, however, the donor's basis in the gifted asset at the time of the gift is greater than the asset's fair market value (FMV) at the time of the gift, then for purposes of determining loss, the donee's basis in the asset is equal to its FMV at the time of the gift.
3. *See* IRC Section 1015(d). Section 1015(d)(6) provides that, for gifts made after Dec. 31, 1976, the donor's carryover basis is increased by the amount of gift tax paid attributable to the appreciation in the asset immediately prior to the gift.
4. Pub. L. No. 107-16.
5. All of the examples in this article assume that individuals making the lifetime transfer have their entire lifetime gift tax exemption available and that the individual owning the assets at death has her entire indexed estate tax exemption remaining at death.
6. For purposes of all of the examples in the article, all post-gift asset exchanges are assumed to have been accomplished by the donor purchasing the gifted assets for cash. We'll discuss additional post-gift asset exchange techniques in a follow up article.
7. 2012 HR 8.
8. IRC Sections (1)(e) and (h).
9. IRC Section 1411(a)(1).
10. IRC Section 1411(a)(2).
11. The 2033 projected exemption amount of $8.95 million used for purposes of the calculations in this article is based on an average rate of inflation as projected by Bernstein Global Wealth Management. *See* Paul S. Lee, "Paradigm Shift: The ATRA-Math (Planning after the American Tax Relief Act of 2012)," (May 2013).
12. If the exemption amount in 2033 is only $7,542,264, owning the asset at death in 2033 versus making a gift of the asset in 2014 would be tax-neutral. That is, the estate tax liability resulting from the inclusion of the assets in the gross estate (($25 million x .40) – ($6.655 million x .40) = $6,983,094.40) would be the same as the combined gift tax liability (($10 million x .40) – ($5.34 million x .40) = $1.864 million) and income tax liability (($2.5 million – $3,419,200) x .238 = $5,119,094.40) resulting from a gift of the asset in 2014. However, a gift of the asset in 2014 coupled with a post-gift asset exchange would still result in a total tax savings of $5,119,094.40.
13. *See* IRC Sections 408(m) and 1(h)(4).
14. This rate assumes that the trust is subject to the alternative minimum tax (AMT).
15. This rate assumes that the trust is subject to the AMT.

New York Considerations

Without a post-gift asset exchange, a lifetime gift wouldn't be tax efficient

Scenario A:	**Stock Owned at Death in 2033**
Exemption Amount in 2033	$8.95 million
Federal Exemption Amount in 2033	$8.95 million
State Exemption Amount in 2033	$1 million
Federal Estate Tax Rate	40%
State Estate Tax Rate	16%
Federal Estate Tax Paid	$5,033,280
State Estate Tax Paid	$3,466,800
Beneficiary's Basis in Stock	$25 million
Capital Gains Tax Rate	20%
Net Investment Income Tax (NIIT)	3.8%
New York Income Tax Rate	8.82%
New York City Income Tax Rate	3.88%
Effective Rate	36.5%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .365= $0
Total Taxes Paid	$8,500,080 + $0 = $8,500,080
Scenario B:	**Gift of Stock in 2014**
Exemption Amount at Time of Gift	$5.34 million
Federal Gift Tax Rate	40%
Federal Gift Tax Paid	($10 million x .4) – ($5.34 million x .4) = $1.864 million
Trust's Basis in Stock	$2 million + $1,491,200 = $3,491,200
Capital Gains Tax Rate	20%
NIIT	3.8%
New York Income Tax Rate	8.82%
New York City Income Tax Rate	3.88%
Effective Rate	36.5%
Gain on Pre-Death Appreciation	($10 million - $3,491,200) x .365= $7,850,712
Total Taxes Paid	$1.864 million + $7,850,712 = $9,714,712
Scenario C:	**Gift of Stock in 2014 With Post-Gift Asset Exchange**
Exemption Amount at Time of Gift	$5.34 million
Federal Gift Tax Rate	40%
Federal Gift Tax Paid	($10 million x .4) – ($5.34 million x .4) = $1.864 million
Trust's Basis in Assets After Exchange	$25 million
Capital Gains Tax Rate	20%
NIIT	3.8%
New York Income Tax Rate	8.82%
New York City Income Tax Rate	3.88%
Effective Rate	36.5%
Gain on Pre-Death Appreciation	($25 million - $25 million) x .365= $0
Total Taxes Paid	$1.864 million + $0 = $1.864 million

— Jay D. Waxenberg and Nathan R. Brown