Estate planning for highly appreciated stocks

Despite market reversals, large unrealized gains still reside in many long-held stock portfolios built up during the record 1982-1999 expansion. How do such assets fit into an estate plan?

Many estate plans include a program of regular gifts. From a tax perspective, gifts have three advantages over estate transfers: The first $12,000 in transfers is shielded from tax by the annual gift tax exclusion; appreciation in the value of the gift after the transfer avoids taxes (effecting an "estate freeze"); and any gift tax that is assessed is computed in a manner that is more favorable to taxpayers.

However, when the gift is to be of highly appreciated securities, there is an important tax caveat. Such a gift comes with a potential capital gain tax attached to it. The recipient of the gift takes the donor's basis in the stock. When he or she later decides to sell the stock, the tax on the capital gain will erode the value of the resource severely.

In contrast, the basis of property received through an estate is generally "stepped up" to its fair market value. Capital gain taxes will be due only on appreciation in value after the decedent's death.*

For married couples these rules suggest a simple tax strategy. For example, at his death a husband bequeaths the appreciated stock to his surviving wife. The marital deduction eliminates estate tax at that time. The wife, in turn, may make a gift of the stock with a fully stepped-up basis. When family members receive these shares, they won't have to be so concerned about capital gain taxes. The wife may, however, need to keep possible gift tax liabilities in mind and may want to spread such gifts over a number of years.

Other ideas stock in the estate planner's toolkit for highly appreciated stock

- *Charitable trusts.* For the philanthropically minded, a charitable remainder trust or a charitable lead trust can be an excellent way to obtain tax-free diversification of appreciated assets. There is no capital gains tax when the trustee sells low-basis, high-value assets and reinvests the proceeds for higher yield. A wide variety of choices is available to those

designing a charitable trust, enough to meet both charitable and private financial objectives on a tax-efficient basis.

- *Private annuities*. A private annuity is a sale by one family member to another in exchange for the buyer's unsecured promise to make specific periodic payments to the seller for life. There is no gift tax due on a properly structured sale, and the assets will be removed from the seller's estate. A portion of each annuity payment is a return of capital (part capital gain and part nontaxable return of basis), and the balance is taxed as ordinary income. However, annuity payments by the buyer are not deductible, and so are made with after-tax dollars.

- *Family limited partnerships*. A fairly new approach to managing family wealth is the family limited partnership. This technique provides for consolidation of assets for convenient management, segregation of assets for protection against claims of creditors, and the potential for gift tax valuation discounts. Typically, parents act as general partners, making gifts of small limited partnership interests to children over a period of years. Properly structured, such gifts generally qualify for the $12,000 annual gift tax exclusion.

*The stepped-up basis is scheduled for partial repeal when the estate tax is repealed in 2010. Just $1.3 million of assets will then receive a stepped-up basis. Any excess will carry over the decedent's basis. An additional $3 million basis step-up will be allowed on assets going to a surviving spouse.

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