What to Do With All This Appreciated Stock?

In the six-year period beginning March 9, 2009 and ending March 9, 2015, the S&P 500 gained more than 207%. As such, it is considered one of the strongest bull markets in terms of both duration and magnitude. Many clients are holding stock positions that have appreciated significantly, and may be reluctant to sell their appreciated stocks and recognize the gain. To make matters worse, the capital gains tax rate is higher now than it has been in almost two decades.

Example 1. A client who purchased 10,000 shares of ABC Corp. on March 9, 2009 paid $74,100 ($7.41 per share). The client held those shares for 6 years, at which point they were worth $256,400 ($25.64 per share). The client sold these shares, recognizing appreciation of $182,300, which was subject to capital gains tax. If the client is in the highest marginal income tax bracket, the capital gains tax rate of 20% and the net investment income tax rate of 3.8% results in a total tax of $43,387. Depending on the client's state of residence, there also may be an additional 3.2% to 13.3% state income tax.

While capital gains tax rates are high, changes in other parts of the tax code have created greater opportunities for clients to make lifetime gifts. Given this context, clients may be interested in considering what opportunities for planning exist for appreciated stock.

Gifting Appreciated Stock to Children, Grandchildren or Friends

The opportunity for making lifetime gifts without paying tax is better than it ever has been. Every individual has available a certain amount, sometimes called the lifetime exemption, to give away during life without paying gift tax. Throughout the prior bull market, which lasted from 2003 through 2007, the lifetime exemption amount was $1,000,000. This year, the lifetime exemption amount is $5,430,000. To the extent that a client makes gifts that use a portion of the lifetime exemption, it will reduce the estate tax exemption that is available at death. Every dollar over the exemption amount that does not otherwise qualify for a deduction will be subject to either federal gift or estate tax at a rate of 40%.

While at record high levels, the lifetime exemption is limited. Accordingly, clients will want to consider and select target assets carefully so as not to waste the exemption. Appreciated securities often are not the best assets for making outright gifts to children or other individuals. The recipient acquires the gift giver's cost basis, and so the gift has a built-in tax liability. As a result, the cost of the gift – the amount of exemption the giver is required to use – will be greater than the value of the gift – the after-tax benefit to the recipient.

Example 2. Consider the client in Example 1. If the client transfers the stock to his daughter, she will take his basis. If she sells the stock right away, she will recognize appreciation of $182,300, which will be subject to capital gains tax. Even if she is in a lower tax bracket than the client and is not subject to the net investment income tax, she will owe a capital gains tax of $27,345. Because of the built-in capital gains tax liability, the net benefit of the gift to the daughter is $229,055. And the client had to use $256,400 of his lifetime exemption. Thus, the "cost" of his gift was greater than the benefit to his daughter.

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Not So Fast …

Highly appreciated stock might not at first blush be the best asset for making outright gifts; however, there are other factors to consider. For one, clients may have difficulty identifying assets without some built-in gain and should not refrain from considering lifetime gifts solely for this reason. Also, if an asset is expected to continue to appreciate, making the gift now will remove the future appreciation from gift and estate tax exposure. Further, while an outright gift might not be ideal, many clients implement structures that provide certain benefits to the family, increase the value of the gift and decrease the cost of the gift.

For example, a client might consider creating a family limited partnership ("FLP") to help with family governance, succession planning and investment implementation and coordination. It might make sense to fund the FLP with securities and gift the interest in the FLP to children, grandchildren or a trust for their benefit. In addition to the substantial non-tax benefits of FLPs, a client who transfers an interest in the FLP may justify a valuation discount for gift tax purposes from the value of the underlying assets. This, in effect, reduces the "cost" of the gift.

Gifting Appreciated Stock to Charity

Philanthropically inclined clients might consider gifting appreciated stock to a favorite charity, donor advised fund or family foundation. A client who makes a gift of long-term capital gain property is entitled to deduct for income tax purposes the fair market value of the gift. Further, contributing appreciated stock to a charity does not give rise to taxable gain to the client. When the recipient charity sells the shares of the appreciated stock, capital gains tax will not be due because the charity is tax-exempt. Thus, the appreciation escapes capital gains tax permanently.

Example 3. Suppose the client in Example 1 contributed to charity his 10,000 shares of ABC Corp. on March 9, 2015. The transfer of the shares to the charity is not a taxable event to the client. The charity's subsequent sale of the shares results in no capital gains tax because the charity is tax-exempt. Thus, the built-in appreciation of $182,300 escapes capital gains tax entirely. In addition to avoiding the capital gains tax, the client is entitled to an income tax deduction for the full value of the gift, which is $255,950 (number of shares times $25.60 (averaged between the highest and lowest selling prices)). Assuming the client pays tax at the highest marginal tax rate (39.6%), the income tax deduction would result in a reduction of the client's income tax bill of $101,356.

Consider the results if, instead of contributing appreciated stock, the client decided to sell the ABC Corp. stock and contribute the proceeds to charity. After paying the tax, the client's net proceeds from the sale of ABC Corp. are $213,013. If the client gives the net proceeds to charity, the income tax deduction would result in a reduction of the client's income tax bill of $84,353. By contributing the stock instead of the proceeds, the client saves $60,390 in tax, and the charity receives $43,387 more.

Many charities are equipped to receive gifts of stock. If not, or if a client wants to make gifts of stock to multiple charities, it might make sense to consider a donor advised fund.

Gifting to Individuals and Heirs

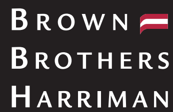
Clients who wish to benefit a charity and one or more individuals might consider using appreciated stock to fund a charitable remainder trust ("CRT"). A CRT is an irrevocable trust that provides for a stream of payments to one or more individuals for a period of time. At the end of the term, the assets remaining in the trust are distributed to the client's charity of choice. The client may be the beneficiary of the payment stream, or the client could designate another person as the beneficiary.

The client receives a current charitable income tax deduction for the present value of the remainder gift to charity. The assets in the CRT are not subject to income tax within the trust. So, when the CRT sells the appreciated stock, the CRT does not recognize the gain. However, the income stream is taxable to the recipient as it is distributed over the term. As such, the CRT is a tax-deferral technique but not a tax-avoidance technique. The CRT often is used if a client intends to liquidate the appreciated position shortly after funding the CRT.

Example 4. Suppose the client in Example 1 creates a CRT and funds it with his ABC Corp. shares. The CRT is structured to pay his daughter ten annual payments of 10% of the value of the trust. The client is entitled to take a charitable income tax deduction of $90,755, reducing his tax bill by $35,939. He will use $165,644 of his lifetime exemption. Assuming an 8% total return, the daughter will receive annual payments totaling $231,475. The annual payments that are distributed to the daughter will carry out the gain and be taxed to her.

Conclusion

When considering planning opportunities for appreciated stock, it is important to structure the gift in a tax efficient manner in order to maximize its impact to your family or to your favorite charity. Your Brown Brothers Harriman Wealth Planner would be pleased to meet with you to discuss your planning and philanthropic goals. ■



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PB_03078_2019_09_06
Exp. 11/30/2021

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