By Joseph C. Mahon

The "TEA" Factor

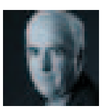
How much appreciation must occur for a gift to provide estate tax savings greater than income tax costs?

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010) has been described as an estate planning "game-changer," with its 35 percent rate and $5 million estate, gift and generation-skipping transfer (GST) tax exemption.[1] How long these taxpayer friendly provisions stay in the law remains to be seen. Given the uncertainty of the U.S. fiscal posture, one common recommendation professional estate planners give to clients is to make lifetime gifts to use the $5 million exemption before these tax benefits are taken away.

But clients need to exercise caution when making these gifts. The transfer tax benefits of TRA 2010 render income tax planning a more important aspect of estate planning. Under the current estate tax regime, gifts still get a carryover basis for income tax purposes, potentially preserving income taxes that may offset the estate tax savings of lifetime gifts. One way to analyze the point at which the income tax costs exceed the estate tax savings is by calculating the "tax efficient appreciation" (TEA) factor.

Tension Between Tax Structures

TRA 2010 brings the estate and gift tax rate closer to the income tax rate than it has been in recent history. The difference between the 35 percent federal estate tax rate and the 15 percent federal capital gains tax rate is a mere 20 percentage points.[2] As set forth in "Federal Tax History," this page, this gap is the closest that the estate tax and capital gains tax rates have been in the past 25 years. This new relationship between the income tax and the estate tax requires increased caution in gift planning.



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When low basis, appreciated property is gifted, it will carry an income tax liability resulting from carryover basis.[3] The heirs may avoid this income tax liability if the donor retains the property until death and the heirs claim a date-of-death basis.[4] But then, estate taxes will be imposed on the full date-of-death value of the property, including the appreciation that would have arisen after a lifetime transfer.

Given this tension between income and estate taxes, the following question arises: How much estate tax savings are necessary to offset the income tax liability? More specifically, how much appreciation must occur post-gift/pre-death for a gift to provide estate tax savings greater than the income tax costs? When does the gift become tax efficient?

TEA Factor

The TEA factor provides an analytic tool to answer these

Federal Tax History

The estate and capital gains rates are the closest they've been in 25 years

Years	Estate Tax	Capital Gains Tax	Difference
2010–2012	35%	15%	20%
2007–2009	45	15	30
2002–2006	46–50	15	31–35
1997–2000	55	20	35
1986–1996	55	28	27
1983–1986	55	20	35

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questions. The exercise of determining the TEA factor provides perspective on those gift tax strategies that provide the greatest overall tax benefit.

The analysis starts with Internal Revenue Code Section 1015, which provides that the donee of a lifetime gift receives a carryover basis for purposes of determining gains. The statute defines carryover basis as the lesser of the donor's basis or the fair market value (FMV) of the gift at the time of the transfer. The purpose of the FMV rule is to avoid gifts that are made to transfer losses that may then be used to avoid income taxes. The regulations specifically recognize that if a donee later sells gifted property for more than its value at transfer but less than the donor's basis, then no gain or loss is recognized upon the later sale.[5]

Because of IRC Section 1015, when appreciated property is gifted, it remains subject to an embedded capital gains tax. For a gift to be tax efficient, the capital gains tax needs to be offset by the projected estate tax savings on post-gift/pre-death appreciation. Basically, the capital gains tax on all of the pre-death appreciation needs to be less than the estate tax on the post-gift/pre-death appreciation to realize net tax savings. Under TRA 2010, the 15 percent federal capital gains tax on all pre-death appreciation may be compared to the 35 percent estate tax on post-gift/pre-death appreciation, setting aside for the time being the impact of state taxes. This comparison can be expressed as a factor—the TEA factor—determined using the formula set forth in "TEA Factor Formula," this page.

"How the Formula Works," this page, illustrates the application of the TEA factor. The assumption is a gift of $5 million, which includes $1 million of appreciation at the time of the gift. Only federal estate tax and income tax rates are projected. In the example, post-gift/pre-death appreciation of $750,000 is needed to create estate tax savings of $262,500 (35 percent of $750,000) to offset the income tax cost of $262,500 (15 percent of $1 million plus $750,000).

Four Steps

Follow these four steps to come up with the TEA factor.

TEA Factor Formula

Compare the 15 percent federal gains tax on all pre-death appreciation with the 35 percent tax on post-gift/pre-death appreciation

TEA factor = 1 + [Unrealized appreciation (Income tax rate / estate tax rate – income tax rate) / total gift], or

$$\text{TEA factor} = 1 + \frac{\text{UA (ITR / ETR – ITR)}}{\text{Total gift}}$$

UA – unrealized appreciation
ITR – projected income tax rate (pre- and post-gift)
ETR – projected estate tax rate

— *Joseph C. Mahon*

How the Formula Works

In this example, a $5 million gift with $1 million unrealized gain needs to appreciate by a factor of 1.15 to a post-gift/pre-death value of $5.75 million

$$\text{TEA factor} = 1 + \frac{\text{UA (ITR / ETR – ITR)}}{\text{\$5 million total gift}}$$

$$\text{TEA factor} = 1 + \frac{\text{\$1 million (.15 / .35 – .15)}}{\text{\$5 million}}$$

$$\text{TEA factor} = 1 + \frac{\text{\$1 million (.75)}}{\text{\$5 million}}$$

$$\text{TEA factor} = 1 + \frac{\text{\$750,000}}{\text{\$5 million}}$$

TEA factor = 1 + .15

TEA factor = 1.15

UA – unrealized appreciation
ITR – projected income tax rate (pre- and post-gift)
ETR – projected estate tax rate

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Step 1: Divide the projected income tax rate by the excess of the projected estate tax rate over the projected income tax rate. Of course, it's the excess of the estate tax rate over the income tax rate that makes the gift worthwhile for tax planning purposes; if the income tax rate exceeds the estate tax rate, then the gift will never result in overall tax savings.

Step 2: Multiply the unrealized appreciation by the result of Step 1.

Step 3: Divide the result of Step 2 by the value of the entire gift.

Step 4: Add the result of Step 3 to the number one, to provide the multiple by which the gift needs to appreciate to create estate tax savings sufficient to offset the income tax liability inherent in the appreciation at the time of the gift.

Zero-basis Collectibles

An extreme example makes the application of the TEA factor all the more interesting. Consider the potential gift of very low or zero-basis collectibles having an FMV of $5 million, by either an artist or an heir attempting to preserve a physical legacy. Collectibles don't qualify for the 15 percent capital gains tax rate, but are instead subject to the historical 28 percent rate.[6] This difference of only seven percentage points from the 35 percent federal estate tax rate becomes quite significant, as illustrated in "Zero-basis Collectibles," this page. The formula indicates that the zero-basis collectibles will have to increase in value by a TEA factor of five to realize any net tax savings—from $5 million to $25 million!

The explanation is simple: As the difference between the income tax rate and the estate tax rate gets smaller, that much more appreciation is needed to create estate tax savings adequate to offset the income tax costs of giving appreciated property. In "Zero-basis Collectibles," the post-gift/pre-death appreciation creates net tax savings at a rate of 7 percentage points to offset income taxes at a rate of 28 percent; this four-to-one ratio requires a lot of appreciation to create net tax savings.

Zero-basis Collectibles

The post-gift/pre-death appreciation creates a net savings of 7 percentage points to offset income taxes at a rate of 28 percent

TEA factor for $5 million zero-basis collectibles
1 plus $5 million [.28/(.35-.28)] / $5 million
1 plus $5 million [.28/.7] / $5 million
1 plus $5 million [4] / $5 million
1 plus 4 = 5
TEA = $5 million x 5 = $25 million
For tax savings, $5 million zero-basis collectibles need to appreciate to $25 million post-gift/pre-death.

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State Taxes

Understanding the impact of the difference between income and estate tax rates on the potential tax savings, the analysis gets even more interesting when state taxes are taken into account. At first blush, state death taxes would appear to increase the projected estate tax rate. However, the Bush era repeal of the state death tax credit has greatly reduced the number of states that continue to impose an estate, inheritance or gift tax. Current surveys indicate that only 19 states continue to impose an estate or inheritance tax. Most of those states are located in the northeast and midwest.[7] High-net-worth individuals having estates with assets in excess of $10 million tend to move to states that have warmer, milder climates and no death tax. As a result, for planning purposes, when applying the TEA factor, it may not be reasonable to project an estate tax rate greater than the federal rate of 35 percent.[8]

In contrast, the beneficiaries of gifts made by well-tanned, high-net-worth individuals are more likely to be younger and to live, work and raise families in jurisdictions that impose income taxes. Recent surveys indicate that at least 40 states and the District of Columbia impose income taxes that include taxes on capital gains.[9] The income tax rates can be quite high. New York has a top rate of 8.97 percent (plus New York City taxes), New Jersey 8.97 percent, Connecticut 6.5 percent and California 10.3[10] percent. These four states account for over 20 percent of the nation's population.[11] Further, the application of the alternative minimum tax to many high-income beneficiaries will deny them the full benefit of a deduction for state income taxes paid.[12] As a result,

When There's a 10 Percent State Income Tax

To realize savings, gifts need to appreciate to $10 million post-gift/pre-death

TEA factor for $5 million transfer, $3 million basis
1 plus $2 million [.25/(.35-.25)] / $5 million
1 plus $2 million [.25/.10] / $5 million
1 plus $2 million [2.5] / $5 million
1 plus 1 = 2
TEA = $5 million x 2 = $10 million

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when applying the TEA factor, it may be appropriate to increase the income tax rate from 15 percent to 20 percent or more, perhaps even to 25 percent.

"When There's a 10 Percent State Income Tax," this page, illustrates the TEA factor for a gift of $5 million that includes $2 million of unrealized appreciation. The projected estate tax rate is maintained at 35 percent, and the projected income tax rate is increased to 25 percent. With these assumptions in place, the TEA factor becomes two so that the investment needs to double in value to realize any tax savings. Compare this result to "How the Formula Works," (p. 47) and consider how the variables of the amount of unrealized appreciation in a gift and the projected estate and income tax rates can create significant differences in the post-gift/pre-death appreciation necessary to realize net savings through estate planning.

What to Do

The TEA factor quantifies the income tax cost of lifetime gifts and the post-gift/pre-death appreciation necessary for gifts to be successful in creating overall tax savings. At the same time, it poses the question of how to plan for the consequences that it illustrates.

Three approaches can be taken. And two of these approaches involve estate-planning techniques already in use.

1. **Accept the tax cost of gifting.** The client can simply accept the TEA factor as the post-gift/pre-death investment hurdle to be cleared for the gift planning to work. Consider the results of "How the Formula Works," (p. 47) and "When There's a 10 Percent State Income Tax," (this page).

   In "How the Formula Works," the client knows that he needs to have the $5 million of gifted property appreciate by 15 percent post-gift/pre-death. If the client feels sanguine about his health and investment prospects, the hurdle may simply be recognized and accepted. The client may justifiably believe that the investment can readily be achieved within his life expectancy. At a rate of return of 3 percent, which reflects the recent history of the IRC Section 7520 rate, the goal may be reached within five years.[13]

   In "When There's a 10 Percent State Income Tax," the investment hurdle is significantly higher—100 percent appreciation post-gift/pre-death. Even if this client feels sanguine about his health, this hurdle rate may create reason to pause. Applying the "Rule of 72" (that is, the time money takes to double in amount can be roughly estimated by dividing the number 72 by the projected rate of return), a 3 percent investment return will require 24 years to cause the gifted property to double in value.[14]

   Alternatively, some clients may adopt the approach that the asset will never be sold. They may consider it more important to avoid an involuntary gift tax at death than to avoid income taxes that aren't expected to arise.

2. **Discount the gift.** The TEA factor could be reduced through planning strategies. Consider strategies or factors that discount the value of property being transferred, including discounts for lack of control and marketability and qualified personal residence trusts (QPRTs). When the value of the property being transferred is reduced, the unrealized appreciation inherent in the gift is reduced, so that the formula reduces the TEA factor. The post-gift/pre-death appreciation may also become easier to realize.

   Interestingly, an income tax benefit may arise if the value of the gift is reduced below the donor's cost basis in the property. Under IRC Section 1015, the donee's basis for gains is the donor's basis for gains purposes, but for loss purposes, it's the lesser of the donor's basis or FMV at transfer.[15] If property, such as real estate transferred to a QPRT, has fallen in value since acquisition or is discounted below its cost basis, the TEA factor isn't just minimized or avoided. In addition, income tax basis may be preserved to avoid capital gains when the property is eventually sold. In contrast, if the property is held until death, the basis may be adjusted downward to the property's date-of-death value.

3. **Avoid the TEA factor.** The TEA factor may simply be avoided, through any one or more of several strategies. Cash or high basis assets may be gifted to avoid transferring unrealized appreciation. Appreciated assets can be put into grantor retained annuity trusts (GRATs), so that the donor retains the appreciation up to the funding of the GRAT and only makes a gift of the post-transfer appreciation. Insurance planning may avoid the TEA factor, since most insurance proceeds are payable free from income taxes.[16]

   Also, grantor trust planning will allow a donor to retain the income tax liability, enhancing the value of the gifted property. An inter vivos credit shelter trust for the benefit of the donor's spouse is one type of grantor trust that may be appropriate for the $5 million exemption. Another common grantor trust structure is for the grantor to retain the ability to substitute assets. Under this structure, a particularly attentive grantor may be able to allow the beneficiaries to enjoy the post-gift appreciation and then take back the income tax liability by substituting cash or other high basis assets having the same value.[17]

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Endnotes

1. Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010, Pub. L. 111-312, enacted Dec. 17, 2010, (TRA 2010), amending Internal Revenue Code Section 2001 as to rates and IRC Section 2010 as to exemption amounts.
2. IRC Section 1(h).
3. IRC Section 1015.
4. IRC Section 1014.
5. *See* the example in Treasury Regulations Section 1.1015-1(a)(2).
6. IRC Sections 1(h)(4) and (5).
7. For a useful map showing the jurisdictions that impose death taxes, *see www.lifeinsuranceselling.com/Issues/2010/February-2010/Pages/State-death-taxes-The-new-planning-concern.aspx*. For a state-by-state summary (including the District of Columbia), *see www.policyandtaxationgroup.com/pdf/Status-State-Death-Tax-Chart.pdf*.
8. When the client is expected to die in a state that has an inheritance or an estate tax based on the federal state death tax credit under now-repealed IRC Section 2011, the additional tax benefit of avoided state death taxes on the amount being gifted should be taken into account. This can be done by projecting those tax savings as a specific dollar amount based upon the value of the gift and the effective rate of state tax after taking into account the IRC Section 2058 deduction for state death taxes and then treating that specific dollar amount as appreciation already realized to achieve tax efficiency.
9. *See, for example,* the American Council for Capital Formation Special Report dated October 2008 at *www.accf.org/media/dynamic/4/media_494.pdf*.
10. As of Jan. 1, 2001. State tax rates are subject to change over time. The Tax Foundation maintains a useful chart of state income tax rates (including the District of Columbia) at *www.taxfoundation.org/taxdata/show/228.html*.
11. *See www.statemaster.com/graph/peo_pop-people-population*.
12. IRC Section 56(b)(1)(A)(ii).
13. The history of the IRC Section 7520 rates may be found at *www.irs.gov/businesses/small/article/0%2C%2Cid=112482%2C00.html*.
14. Under the Rule of 72, the time that money takes to double in amount can be roughly estimated by dividing the number 72 by the projected rate of return. An explanation may be found at *www.en.wikipedia.org/wiki/Rule_of_72*.
15. IRC Section1015(a).
16. IRC Section 101(a), subject to the transfer-for-value rule of IRC Section 101(a)(2).
17. Explanation of each of these planning techniques is beyond the scope of this article. Revenue Ruling 2008-22, 2008-16 I.R.B. 796 (April 21, 2008), illustrates the viability of grantor trust planning that relies upon a power to substitute property under IRC Section 675(4).