

Money Matters

May 1, 2024

Skloff Financial Group Question of the Month

By Aaron Skloff, AIF, CFA, MBA

Q: We read ‘How a Gift Can Be a Tax Dream or a Tax Nightmare’ Part 1. We are considering gifting assets to our children and/or our parents? What are the tax benefits and detriments of gifting?

The Problem – How a Gift Can Be a Tax Dream or a Tax Nightmare

Many people gift assets to their children and/or parents with the best intentions. Those gifts may generate tax benefits to you, your children, your parents, or all parties – **a tax dream**. On the other hand, those gifts may generate tax detriments to you, your children, your parents, or all parties – **a tax nightmare**.

The Solution – A Side-by-Side Comparison of a Tax Dream to a Tax Nightmares

By examining a side-by-side comparison in the chart below, you can see how a gift can create a **tax dream** or a **tax nightmare**.

Gifts That Generate Tax Detriments to Parents, Children or Both – A Tax Nightmare

To simplify the comparison, all parties are not subject to tax on a child’s investment and other unearned income (Kiddie Tax) or state taxes.

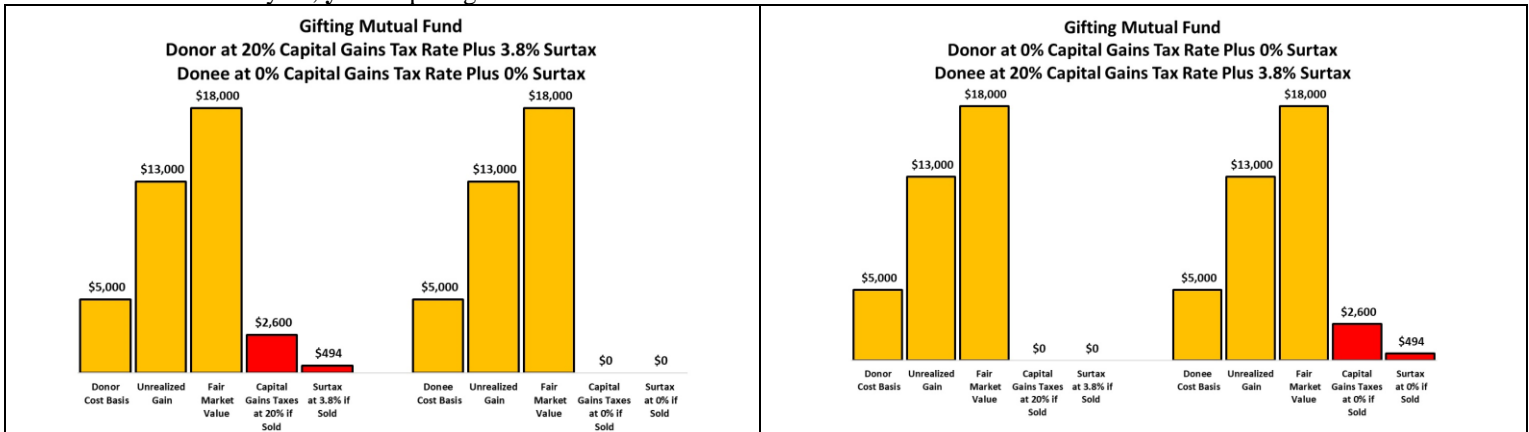
If you (“donor”) gift a \$18,000 mutual fund, for which you originally paid (“cost basis”) \$5,000, to one of your children and/or your parent (“donee”), neither you nor they have to pay a **gift tax** – **a tax dream**.

Gifting Mutual Fund – Donor at 20% Capital Gains Tax Rate Plus 3.8% Surtax - Donee at 0% Capital Gains Rate Plus 0% Surtax. If your child and/or parent immediately sells the \$18,000 mutual fund, they may be subject to a capital gains tax on the \$13,000 gain based on how long **you** owned the mutual fund and **their** income level. The capital gains tax rate is **their** income tax rate for short term capital gains if **you** owned the mutual fund for one year or less. Based on **their** low income, **their** income tax rate would be **0%** - **a tax dream**. If it is a long term capital gain because **you** owned the mutual fund for more than one year, **their** capital gains tax rate, based on **their** low income, would be **0%** - **a tax dream**. The mitigation or elimination of taxes is a form of legal tax arbitrage.

Instead, had you sold the mutual fund, and realized a short term capital gain, based on **your** high income, **your** income tax rate would be **37%** - **a tax nightmare**. Instead, based on **your** high income, had you sold the mutual fund, and realized a long term capital gain, you would have been subject to a **20%** capital gains tax of \$2,600 (\$13,000 X 20%) - **a tax nightmare**. In addition to the capital gains tax, based on **your** high income, you would have been subject to an additional **3.8%** investment surtax of \$494 (\$13,000 X 3.8%) - **a tax nightmare**.

Gifting Mutual Fund – Donor at 0% Capital Gains Tax Rate Plus 0% Surtax – Donee at 20% Capital Gains Rate Plus 3.8% Surtax. If your child and/or parent immediately sells the \$18,000 mutual fund, they may be subject to a capital gains tax on the \$13,000 gain based on how long **you** owned the mutual fund and **their** income level. The capital gains tax rate is **their** income tax rate for short term capital gains if **you** owned the mutual fund for one year or less. Based on **their** high income, **their** income tax rate would be **37%** - **a tax nightmare**. Based on **their** high income and based on a long term capital gain, they would be subject to a **20%** capital gains tax of \$2,600 (\$13,000 X 20%) - **a tax nightmare**. In addition to the capital gains tax, based on **their** high income, they would have been subject to an additional **3.8%** investment surtax of \$494 (\$13,000 X 3.8%) - **a tax nightmare**.

Instead, had you sold the mutual fund, and realized a short term capital gain, based on **your** low income, **your** income tax rate would be **0%** - **a tax dream**. Instead, based on **your** low income, had you sold the mutual fund, and realized a long term capital gain because **you** owned the mutual fund for over one year, **your** capital gains tax rate would be **0%** - **a tax dream**.



Action Steps

Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

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