

Tax-efficient inter-generational wealth transfer

'Upstream' gifting may help you save on taxes.

Fidelity Wealth Management



Key takeaways

There are 2 primary methods of transferring wealth, either gifting during lifetime or leaving an inheritance at death.

"Upstream" gifting, that is, making a gift to an older family member rather than directly to a younger family member, may be advantageous.

Consult your tax and financial professionals to walk through the potential scenarios and to help you determine whether these strategies are right for you.

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exposure to estate, gift, and capital gains taxes may have several options at their disposal. But to execute a wealth-transfer strategy effectively, it's important to understand exactly what effect the rules governing the transfer and taxation of assets between generations could have on your family.

Understanding the fundamentals of wealth transfer

There are 2 primary methods of transferring wealth, either gifting during lifetime or leaving an inheritance at death.

Individuals may transfer up to \$15 million (as of 2026) during their lifetime or at death without

incurring any federal gift or estate taxes. This is referred to as your lifetime exemption. In addition, individuals may gift up to \$19,000 annually to any individual without incurring any federal gift tax liability or using the lifetime exemption. This annual gift exclusion must be used within the year and does not carry over or accumulate. For example, if you gifted your child \$20,000 in 2026, the first \$19,000 would be applied to your annual exclusion and the remaining \$1,000 would use up part of your lifetime exemption amount.

Gifts made during your lifetime in excess of the annual exclusion reduce the amount that can be excluded from the value of your estate at death. For example, if you gave \$3 million in gifts during your life on top of any annual exclusion gifts you may have made, you would only be able to exclude \$12 million from the value of your taxable estate at death in 2026. Any amount of assets above that number would be subject to a 40% federal estate tax, unless transferred to a spouse or charity. Transfers to spouses in life or at death are subject to an unlimited marital deduction and assets transferred to a qualified charity are subtracted from the value of the estate when calculating the estate tax liability. In other words, the value of assets transferred to a spouse or a charity do not count against the lifetime exemption.

Generation-skipping transfer tax

There is another, separate tax that applies to gifts or bequests to grandchildren or great-grandchildren, called the generation-skipping transfer tax (GSTT). The exemption amount is identical to that for the lifetime and estate tax, but is distinct from those in that it is reduced only by lifetime gifts made to a recipient at least 37½ years younger than the gift giver (excluding spouses) above the annual exclusion limit. (Such gifts will also reduce your lifetime estate tax exemption, as well. In other words, it is not an amount in addition to the lifetime exemption.)

Cost basis updates at death

Upon death, the cost basis of assets that are included in a person's estate are updated to reflect the value at the date of death. That is, the original value of the assets may be revised upward or downward to the date of death value.* Inheritors can benefit when the basis is stepped up, as they will not need to pay capital gains tax on any growth that happened prior to the death of the original owner and, in theory, could immediately sell the inherited assets with little or even no capital gains tax burden.

Reducing exposure to taxes with "upstream" gifting

It may be possible to reduce estate tax exposure by gifting upstream. Imagine a parent with a taxable estate in excess of the lifetime exemption who has a \$5 million portfolio with a basis of \$3 million.

The parent wants to transfer these assets into a trust for their children's benefit to remove the assets and any future appreciation from their taxable estate. However, by irrevocably transferring these assets to the children's trust, the parents would forfeit the step-up in basis that would occur if they retained the assets until their death. The trust would potentially be responsible for capital gains tax on the \$2 million in gains.

"Upstream" gifting, that is, making a gift to an older family member rather than directly to a younger family member, may allow the parent to take advantage of today's high lifetime gifting exemption (thereby avoiding the estate tax) and the step-up in basis (thereby avoiding the capital gains tax).

How it might work

The parent uses their lifetime gift tax exemption to transfer the assets to their parent (the children's grandparent). This strategy assumes the grandparent has not or is not likely to use up their estate tax or generation-skipping transfer tax exemption. The grandparent modifies their estate plan so that the assets are passed directly to the grandchildren when the grandparent passes away. When the grandparent passes away, the assets receive a step-up in

cost basis. This means the cost basis of the assets is "stepped up" to the market value at the date of death,* effectively erasing any "gains" that have occurred since they were originally acquired.

Important considerations

This strategy is most effective in certain circumstances. First, it is critical that the grandparent not have a taxable estate upon their death. The parent in this scenario should not give the grandparent so much that it exposes the grandparent and the assets to potential estate taxation. So the \$5 million gift to the grandparent, combined with any of the grandparent's own assets, is not expected to exceed the future expected estate tax exemption. Otherwise, the estate tax may eliminate the benefits of the step-up in cost basis, and ultimately reduce the value of assets that can be passed to subsequent generations. Secondly, the grandparent must update their estate plan to ensure these assets are left to the grandchildren. If the estate plan dictates the assets are to be left to the parent and the grandparent dies within 1 year of the gift being made, the parent will inherit the assets, eliminating the benefit of the initial transfer and use of exemption, and will not benefit from the step-up in cost basis. In other words, they would have used their exemption but the assets would be back in their estate and at the same cost basis.

Potential risks

Once the assets are given to the grandparent, the parent has no say in what happens to them. It's possible that the grandparent could change their mind and decide to leave the assets to someone else, perhaps someone the parent disapproves of. The assets would also be subject to the grandparent's creditors. And income from the gifted assets could affect the grandparent's income taxes, Medicare premiums, or eligibility for other benefits. It's also possible that some future legislation or regulation could render this strategy ineffective.

Consult with a professional

This can be a powerful strategy, but how it is implemented will depend significantly on your family's personal circumstances. Consult your tax and financial professionals to walk through the potential scenarios and to help you determine whether these strategies are right for you.

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* There is an option to apply an alternate valuation date, typically 6 months from the date of death. This option is only available if it will result in a reduction of the gross estate and a corresponding reduction in the applicable estate and generation skipping transfer tax.

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