Insight on Estate Planning

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Your IRA owns real estate

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The basics of basis

Basis planning can result in significant tax savings

Traditionally, a key goal of estate planning has been to minimize gift and estate taxes. However, because the exemption amount is at a record high of $5.43 million for 2015, fewer people will be liable for these taxes. Thus, many people have shifted their focus from estate planning to income tax planning. An understanding of basis — and the benefits of the "stepped-up basis" rule — can help you identify valuable tax planning opportunities.

What's basis?

Generally, your basis in a capital asset is the amount you paid for it, adjusted, if appropriate, to reflect certain tax-related items. For example, basis may be reduced by depreciation deductions or increased by additional capital expenditures. For purposes of this article, we'll assume that basis is equal to an asset's original cost.

If you sell an asset for more than its basis, you have a capital gain. If you sell it for less, you have a capital loss. Short-term capital gains (on assets held for one year or less) are taxed as ordinary income. Long-term capital gains are currently taxed at a maximum 20% rate for taxpayers in the highest bracket (0% for taxpayers in the two lowest tax brackets and 15% for all others). Certain high-income taxpayers are subject to an additional 3.8% tax on net investment income, bringing the capital gains rate up to 23.8%.

What's the stepped-up basis rule?

If you gift an asset, the recipient takes over your basis, triggering capital gains taxes in case the asset is sold. But if you bequeath an asset to someone via your will or revocable trust, the recipient's basis is stepped up to the asset's fair market value on the date of death. That means the recipient can turn around and sell the asset income-tax-free.

From an income tax perspective, it's almost always better to hold appreciating assets for life, so your family members or other heirs can take advantage of a stepped-up basis. So why is gifting often viewed as the preferred method of transferring wealth? The answer stems from a time when high estate tax rates and low exemption amounts made estate tax avoidance the primary concern.

Consider this example: In 1984, Melanie bought stock for $400,000. In 1987, when the stock's value had grown to $600,000, she transferred it to an irrevocable trust for the benefit of her son, Jeremy. At the time, the gift and estate tax exemption was $600,000, so Melanie's gift was tax-free.

Ten years later, Melanie dies and the trust distributes the stock, then worth $1.8 million, to Jeremy. Jeremy sells the stock and, because he inherits Melanie's original $400,000 basis, recognizes a $1.4 million capital gain. In 1997, the capital gains rate was 28%, so Jeremy pays $392,000 in taxes. But by gifting the stock in 1987, Melanie removed it from her estate, avoiding estate taxes on the stock's appreciated value. Assuming Melanie's estate was subject to the top tax rate (55% at the time), the estate tax savings totaled $990,000 (55% × $1.8 million).

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In the example, the estate tax savings eclipsed the income tax cost, so gifting the stock was the better strategy. Today, however, the exemption has grown to $5.43 million ($10.86 million for married couples), so only the most affluent families are exposed to estate taxes. Unless your estate is (or will be) large enough to trigger estate taxes, transferring appreciated assets at death generally is the best tax strategy.

What about previous gifts?

Suppose you transferred assets to an irrevocable trust years ago to shield future appreciation from estate taxes, but now your wealth is comfortably within the exemption amount.

Reverse gift minimizes capital gains

If you own highly appreciated, low-basis assets, a "reverse gift" can be an effective strategy for avoiding capital gains taxes. Here's how it works: You transfer the assets to someone (your spouse, for example) whose health is declining, and that person leaves the assets to you in his or her will or revocable trust. When the person dies, you get the assets back with a stepped-up basis, enabling you to sell them tax-free. For this strategy to work, the person must survive for at least one year after you make the gift.

Estate taxes are no longer an issue, but if your beneficiaries sell the assets they'll recognize substantial capital gains. Fortunately, there are techniques you can use to restore the benefits of a stepped-up basis.

If the trust document permits, you can swap low-basis trust assets for cash or other high-basis assets of equal value. Done properly, this enables you to bring the low-basis assets back into your estate, where they'll enjoy a stepped-up basis when you die.

Even if the trust doesn't permit a swap, you may be able to purchase low-basis assets from the trust, with the trustee's consent. It may even be possible to finance the purchase by borrowing the funds or exchanging a promissory note for trust assets. So long as the trust is a "grantor trust" — that is, a trust that you own for income tax purposes — a transaction between you and the trust isn't a taxable event.

Handle with care

If you're considering removing low-basis assets from a trust to reduce your beneficiaries' income taxes, be sure to work with your advisor. One misstep can lead to unintended tax consequences. ▮

Does a private annuity have a place in your estate plan?

When James met with his advisor to review his estate plan, he realized that his overall estate might be worth more than the current $5.43 million gift and estate tax exemption amount. In fact, his estate includes a family business, real estate holdings and a sizable investment portfolio.

James' advisor suggested using a private annuity as a way to reduce his gift and estate tax exposure. Let's take a close look at the pluses and minuses of using a private annuity.

A private annuity in action

In a typical private annuity transaction, you transfer property to your children or others in exchange for their unsecured promise to make annual payments to you for the rest of your life. It's "private" because the annuity is provided by a private party rather than an insurance company or other commercial entity. The amount of the annuity payments is based on the property's value and an IRS-prescribed interest rate.

A properly structured annuity is treated as a sale rather than a gift. So long as the present value of the annuity payments (based on your life expectancy) is roughly equal to the property's fair market value, there's no gift tax on the transaction. And the property's value, as well as any future appreciation in that value, is removed from your taxable estate. In addition, a private annuity provides you with a fixed income stream for life and enables you to convert unmarketable, non-income-producing property into a source of income.

Until relatively recently, private annuities also provided a vehicle for disposing of appreciated assets and deferring the capital gain over the life of the annuity. Proposed regulations issued in 2006 (although not yet finalized) effectively eliminated this benefit, requiring you to recognize the gain immediately. It's still possible, however, to defer capital gain by structuring the transaction as a sale to a defective grantor trust in exchange for the annuity.

Another potential benefit: Because the transferee's obligation to make the annuity payments ends when you die, your family will receive a significant windfall should you fail to reach your actuarial life expectancy. In other words, your family will have acquired the property, free of estate and gift taxes, for a fraction of its fair market value. On the other hand, if you outlive your life expectancy your family will end up overpaying.

Keep in mind that private annuities can't be "deathbed" transactions. If your chances of surviving at least one year are less than 50%, the IRS actuarial tables won't apply and the transfer will be treated as a taxable gift.

Understanding the risks

A disadvantage of many popular estate planning techniques is "mortality risk." For example, the benefits of a grantor retained annuity trust are lost if you fail to survive the trust term. Private annuities, on the other hand, involve "reverse mortality risk." If you outlive your life expectancy, the total annuity payments will exceed the property's fair market value, causing your family to overpay for the transferred property and potentially *increasing* the size of your taxable estate.

To avoid this result, consider a *deferred* private annuity, which delays the commencement of annuity payments, reducing reverse mortality risk. The U.S. Tax Court has given its stamp of approval to a deferred private annuity. In *Estate of Kite v. Commissioner*, the court approved a deferred private annuity transaction, even though the annuitant died before the annuity payments began. As a result, her children received a significant amount of wealth, free of estate and gift taxes, without having to make any payments.

There's also a risk that your child or other transferee will be unable or unwilling to make the annuity payments. Private annuities are unsecured obligations, and if the recipient defaults, the IRS may challenge the arrangement as a disguised gift.

Consult your advisor

Like any estate planning strategy, a private annuity isn't right for everyone. However, if your estate is potentially large enough to be subject to estate taxes, a private annuity may be one way to transfer substantial wealth to your children or other loved ones at a minimal tax cost. Discuss your options with your estate planning advisor. ▮

Estate tax relief for family businesses

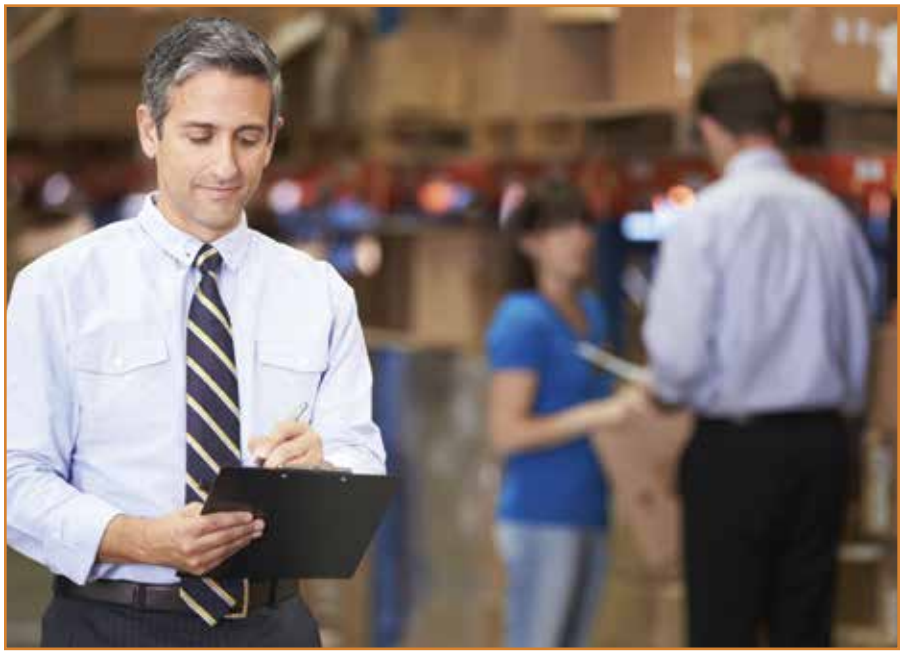
If a substantial portion of your wealth is tied up in a family or closely held business, you may be concerned that your estate will lack sufficient liquid assets to pay estate taxes. If that's the case, your heirs may be forced to borrow funds or, in a worst-case scenario, sell the business in order to pay the tax.

For many business owners, Internal Revenue Code Section 6166 provides welcome relief. It permits qualifying estates to defer a portion of their estate tax liability for up to 14 years. During the first four years of the deferment period, the estate pays interest only, followed by 10 annual installments of principal and interest.

A deferral isn't available for the total estate tax liability, unless a qualifying closely held business interest is the only asset in your estate. The benefit is limited to the portion of estate taxes that's attributable to a closely held business.

Eligibility requirements

Estate tax deferral is available if the value of an "interest in a closely-held business" exceeds



35% of your adjusted gross estate. A business is closely held if it conducts an *active* trade or business and it's:

- A sole proprietorship,
- A partnership or limited liability company — if your gross estate includes 20% or more of its capital interests *or* the entity has 45 or fewer partners or members, or
- A corporation — if your gross estate includes 20% of its voting stock *or* the corporation has 45 or fewer shareholders.

To determine whether you meet the 35% test, you may only include assets actually used in conducting a trade or business — passive investments don't count.

Active vs. passive ownership

To qualify for an estate tax deferral, a closely held business must conduct an active trade or business, rather than merely manage investment assets. Unfortunately, it's not always easy to distinguish between the two, particularly when real estate is involved.

The IRS provided welcome guidance on this subject in a 2006 Revenue Ruling. The ruling confirms that a "passive" owner — such as a limited partner in a limited partnership — may qualify for estate tax deferral, so long as the *entity* conducts an active trade or business. The ruling also clarifies that using property management companies or other independent contractors to conduct real estate activities doesn't disqualify a business from "active" status, so long as its activities go beyond merely holding investment assets.

In determining whether a real estate entity is conducting an active trade or business, the IRS considers several factors, including:

- The amount of time owners, employees or agents devote to the business,
- Whether the business maintains an office with regular business hours,
- The extent to which owners, employees or agents are actively involved in finding tenants and negotiating leases, and
- The extent to which owners, employees or agents perform or oversee repairs and maintenance and handle tenant repair requests and complaints.

The ruling provides several examples to illustrate the necessary level of involvement by owners or employees. In one example, the IRS found that a real estate business failed the active business test because it relied on a third-party management company to operate its properties. Nevertheless, the estate in the example qualified for a tax deferral because the deceased person owned at least 20% of the management company, which, together with the real estate, constituted a single, active business.

Weigh your options

As you plan your estate, consider whether your family will be eligible to defer estate taxes. If you own an interest in a real estate business, you may have an opportunity to qualify it for an estate tax deferral simply by adjusting your level of activity or increasing your ownership in an entity that manages the property.

Estate Planning Pitfall

Your IRA owns real estate

An IRA is a powerful financial planning tool that allows you to save for retirement, or provide benefits for your heirs, on a tax-advantaged basis. Most people invest their IRA funds in stocks, bonds and mutual funds. But others opt for nontraditional investments, such as real estate, in the hope of boosting their returns.

If you choose to hold real estate in your IRA, be aware that there are several tax traps for the unwary, chief among them the prohibited transaction rules. Those rules disallow certain dealings between you (or your beneficiaries) and your IRA.

For example, you and your beneficiaries can't sell or lease property to your IRA, buy or lease property from your IRA, use IRA property as a personal residence or office, lend to or borrow from your IRA, guarantee a loan to your IRA, pledge IRA assets as security for a loan or provide goods or services to your IRA. This last prohibition means you can't provide property management, renovation or construction services, either by yourself or through a family member or a company you control.

Violations of the prohibited transaction rules result in termination of the IRA. That means you'll be liable for taxes and penalties on the *entire* account balance, regardless of the transaction's size.

Other considerations to keep in mind:

- In a traditional IRA, any capital gains eventually will be taxed as ordinary income.
- If real estate is financed by a mortgage, some income may be subject to unrelated business income tax (UBIT).
- Not all IRA custodians permit real estate investments, so you may have to open a self-directed IRA.
- If you have a traditional IRA, it must have sufficient cash or other liquid assets to fund required minimum distributions starting at age 70½.

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