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CERTIFIED PUBLIC ACCOUNTANTS

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TRUST & ESTATE **INSIGHTS**

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Based in Silicon Valley and San Francisco, we deliver the sophisticated solutions, innovative thinking, global capabilities and highly personalized service our clients require to navigate the complexities of their financial worlds, not only for today but for many years to come. Our goal is to exceed our clients' expectations in every way.

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In This Issue

When an Inheritance Is Too Good to Be True: How Income in Respect of a Decedent Works

Most people are genuinely appreciative of inheritances, and who wouldn't enjoy some unexpected money? But in some cases, it may be too good to be true. While most inherited property is tax-free to the recipient, this isn't always the case with property that's considered income in respect of a decedent (IRD). If you have large balances in an IRA or other retirement account — or inherit such assets — IRD can be a significant estate planning issue.

IRD Explained

IRD is income that the deceased was entitled to, but hadn't yet received, at the time of his or her death. It's included in the deceased's estate for estate tax purposes, but not reported on his or her final income tax return, which includes only income received before death.

To ensure that this income doesn't escape taxation, the tax code provides for it to be taxed when it's distributed to the deceased's beneficiaries. Also, IRD retains the character it would have had in the deceased's hands. For example, if the income would have been long-term capital gain to the deceased, such as uncollected payments on an installment note, it's taxed as such to the beneficiary.

IRD can come from various sources, including unpaid salary, fees, commissions or bonuses, and distributions from traditional IRAs and employer-provided retirement plans. In addition, IRD results from deferred compensation benefits and accrued but unpaid interest, dividends and rent.

The lethal combination of estate and income taxes (and, in some cases, generation-skipping transfer tax) can quickly shrink an inheritance down to a fraction of its original value.

What Recipients Can Do

If you inherit IRD property, you may be able to minimize the tax impact by taking advantage of the IRD income tax deduction. This frequently overlooked write-off allows you to offset a portion of your IRD with any estate taxes paid by the deceased's estate and attributable to IRD assets. You can deduct this amount on Schedule A of your federal income tax return as a miscellaneous itemized deduction. But unlike other deductions in that category, the IRD deduction isn't subject to the 2%-of-adjusted-gross-income floor.

Keep in mind that the IRD deduction reduces, but doesn't eliminate, IRD. And if the value of the deceased's estate isn't subject to estate tax — because it falls within the estate tax exemption amount ($5.45 million for 2016), for example — there's no deduction at all.

Calculating the deduction can be complex, especially when there are multiple IRD assets and beneficiaries. Basically, the estate tax attributable to a particular asset is determined by calculating the difference between the tax actually paid by the deceased's estate and the tax it would have paid had that asset's net value been excluded.

If you receive IRD over a period of years — IRA distributions, for example — the deduction must be spread over the same period. Also, the amount includible in your income is *net* IRD, which means you should subtract any deductions in respect of a decedent (DRD). DRD includes IRD-related expenses you incur — such as interest, investment advisory fees or broker commissions — that the deceased could have deducted had he or she paid them. Thus, to minimize IRD, it's important to keep thorough records of any related expenses.

Be Prepared

As you can see, IRD assets can result in an unpleasant tax surprise. Because these assets are treated differently from other assets for estate planning purposes, contact your estate planning advisor. Together you can identify IRD assets and determine their tax implications.

Know Your Options for Business Interest Transfers

Business owners should always know their options when it comes to their company and its relation to their estate plans. Let's take a look at some commonly chosen vehicles for transferring ownership interests in a business.

The Great GRAT

With a grantor retained annuity trust (GRAT), you transfer business interests or other assets to an irrevocable trust. The trust then pays you a fixed annuity for a specified number of years, and at the end of the trust term the trust assets are transferred to your children or other beneficiaries free of any additional gift tax, even if the property has appreciated while held in trust.

GRATs offer several important advantages. Gift tax is based on the actuarial value of your beneficiaries' future interest in the trust assets at the time the trust is funded. Depending on the size of the annuity payments and the length of the term, this value can be very low and can even be "zeroed out." Also, you remain in control of the business during the trust term. And the annuity payments provide a source of income to fund your retirement or other needs.

Keep in mind that for a GRAT to succeed you *must* survive the trust term, and your business must generate enough income or appreciate in value to cover the annuity payments. Also, be aware that legislation has been proposed that would limit the benefits of a GRAT.

The Intriguing IDGT

An intentionally defective grantor trust (IDGT) is an irrevocable trust designed so that contributions to the trust are considered completed gifts for gift and estate tax purposes even though the trust is considered a "grantor trust" for income tax purposes. (That's the "defect.") But the trust is very effective because the trust assets won't be included in your estate. Selling your business to an IDGT, rather than giving it to your beneficiaries outright, allows you to retain control over the business during the trust term while still enjoying significant tax benefits.

Maintaining grantor trust status is important for two reasons: First, *you* pay income taxes on the trust's earnings. Because those earnings stay in the trust rather than being used to pay taxes, you're essentially making additional tax-free gifts to your beneficiaries. Second, because a grantor trust is considered your "alter ego" for income tax purposes, you can sell your business interests to the trust without recognizing capital gains tax.

Four More Options for Transferring Ownership Interests

In addition to GRATs and IDGTs, there are several other options for transferring family business interests to the younger generation, including:

1. ***Outright gifts*.** If you're willing to relinquish control, you can transfer substantial interests tax-free using the $5.45 million exemption.

2. ***Installment sales to family members*.** These offer significant gift and estate tax savings, provided you're ready to part with the business.

3. ***Self-canceling installment notes*.** These require the buyer to pay a significant premium. But, if the seller dies before the note is paid off, the remaining payments are canceled without triggering additional gift or estate taxes.

4. ***Family limited partnerships*.** Family limited partnerships (FLPs) enable you to transfer large interests in the business to family members at discounted gift tax values, while retaining management control. The IRS does scrutinize them closely, however. The gifting of the limited partnership interests allow for shifting of income tax burden from the parent to the child. FLPs also offer a more tax-efficient choice of business entity compared to a corporate structure.

The Need for a Plan

For business owners, strategic planning and estate planning should go hand in hand. To achieve your goals, develop an integrated approach that addresses ownership and management succession issues together with estate planning issues. For help gathering the right information and making the best choice for you, please contact us.

Beware the Transfer-for-Value Rule When Dealing with Life Insurance

Life insurance typically is a key component of an estate plan. To keep the value of a life insurance policy you already own out of your taxable estate, or to achieve other planning goals, it may make sense to transfer the policy. But income tax traps exist. One is the transfer-for-value rule. So before making a transfer, it pays to become familiar with this rule.

Concept and Exceptions

Normally, life insurance proceeds payable by reason of death (that is, death benefits) are not subject to income tax. However, when the transfer-for-value rule applies, the transferee — the person receiving the policy — will be subject to ordinary income taxes on the policy's death proceeds, excluding the consideration paid for the policy and any premiums or other charges he or she pays after the transfer.

The transfer-for-value rule is intended to discourage speculation in insurance policies by people who lack an insurable interest. An insurable interest is a legitimate reason for someone to be insured against your death — typically, this means the person would suffer a financial hardship. Examples of people with an insurable interest on you could include your spouse, child and business partner.

Unfortunately, the rule's design doesn't necessarily jibe with its underlying rationale. For example, though the rule contains several exceptions, there isn't one for transfers to children or other family members who typically *do* have an insurable interest.

So what are the exceptions? One is when the transfer is made to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. Be aware that this exception doesn't apply in reverse, when the transfer is to an officer or shareholder.

Potential Pitfalls

One reason the transfer-for-value rule is so dangerous is that the term "transfer" goes well beyond an outright sale or physical transfer of a policy. A transfer can occur, for example, when you name a beneficiary or assign someone an interest in the policy.

A transfer won't cause the death benefits to become subject to income taxes unless the transferee provides "valuable consideration," but this aspect of the rule can be treacherous as well. Valuable consideration isn't limited to money. It can be virtually anything of value to the transferor — the person transferring the policy or interest.

It's logical to assume that the transfer-for-value rule won't apply to a gift of a policy or of an interest in a policy. In most cases, that's true, but even gift transfers should be examined closely to avoid the transfer-for-value trap.

Plenty of Thought

If you want to transfer a policy, give it plenty of thought. The transfer-for-value rule is a tax trap to which many individuals fall prey. We can help you decide whether a policy transfer is really a good idea and, if so, how to prepare for the tax impact.

The Section 1031 Exchange: Why It's Such a Great Estate Planning Tool

Like many business owners, you might own highly appreciated business or investment real estate. Fortunately, there's an effective tax and estate planning strategy at your disposal: the Section 1031 "like kind" exchange. It can help you defer capital gains taxes on appreciated property indefinitely, and even eliminate them permanently.

The Exchange Game

Sec. 1031 allows you to exchange one or more pieces of business or investment real estate for other business or investment real estate without recognizing capital gain. Despite the term "like-kind," you can exchange an apartment complex for an office building, for example, or a farm for a strip mall. The only limitation is that the value and equity in the new properties should be equal to or greater than the value and equity of the existing properties. If you receive any cash or other non-real-estate property, it'll be currently taxable.

Few Sec. 1031 exchanges involve a direct exchange of one property for another. Most are structured as "deferred exchanges." In other words, you sell your property (the "relinquished" property) and then use the proceeds to acquire new property (the "replacement" property).

Safe Harbors to Be Aware of

The key to avoiding capital gains tax in an exchange is to ensure that you never possess or control the sale proceeds. And the best way to do that is to use one of several IRS safe harbors. With a deferred exchange, you sell the relinquished property (or properties) and engage a qualified intermediary (QI) to hold the proceeds and buy replacement property (or properties). If you identify replacement property within 45 days and complete the purchase within 180 days after the relinquished property is sold, the capital gain is deferred.

With a reverse exchange, you engage a QI to acquire replacement property *before* you sell relinquished property. To defer capital gain, you must identify the relinquished property within 45 days and complete the sale within 180 days. To avoid holding title to relinquished and replacement properties at the same time, you must "park" replacement properties with an "exchange accommodation titleholder" until the transaction is completed.

These and other safe harbors (such as trusts and qualified escrow accounts) aren't the only way to complete a Sec. 1031 exchange. But if you do an exchange outside the safe harbors, the IRS or FTB may challenge it and treat the transaction as taxable.

Harnessing the Power of Estate Planning

Although a Sec. 1031 exchange is best known as a tax-deferral technique, it's also a powerful estate planning tool. Ordinarily, when you sell appreciated real estate you must pay federal and state taxes on the gain at rates as high as 42%, leaving less to pass on to your children or other heirs.

If you hold onto property for life, however, the capital gains disappear. Your heirs receive a "stepped-up basis" in the property equal to its fair market value on your date of death, erasing any previous appreciation in value and allowing them to turn around and sell the property tax-free.

But what if you'd prefer to dispose of it in order to invest in income-producing real estate or to diversify your holdings? That's where a Sec. 1031 exchange comes into play. Rather than selling property, paying capital gains taxes and reinvesting what's left of the proceeds, an exchange allows you to accomplish your goals without losing any of the exchanged property's value to taxes.

Exchanging Properties for TIC Interests

A tactic to consider is exchanging a single property for several tenancy-in-common (TIC) interests. TIC interests are fractional, undivided interests in larger properties. Exchanging real estate for TIC interests not only defers capital gains taxes, but also gives you access to professionally managed, institutional-grade real estate. And it provides some interesting estate planning opportunities.

Suppose Jim owns a highly appreciated apartment building. He wants to divide his estate equally among his children. But he'd prefer not to leave them the building jointly, for fear it'll lead to conflict over whether to sell the building or hold onto it.

If Jim sells the building, he'll be hit with a capital gains tax bill, leaving less for his kids. Instead, he opts for a Sec. 1031 exchange, trading the building for three equally valued TIC interests in a professionally managed real estate investment. When Jim dies, his children each receive a TIC interest with a stepped-up basis and can decide independently whether to sell or hold their interests.

Work with Your Tax Advisor

When it comes to Sec. 1031 exchanges, you have multiple ways to exchange one or more pieces of business or investment real estate. Your tax advisor can help you structure things in the best way for your estate.